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FINANCIAL CONDITION OF THE BANK AND THRIFT INDUSTRIES

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ORIGINAL
COMPLETED

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

PART 1

SEPTEMBER 11, 12, 18 AND 19, 1985

Serial No. 99-66

Printed for the use of the Committee on Banking, Finance and Urban Affairs

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FINANCIAL CONDITION OF THE BANK AND THRIFT INDUSTRIES

WEDNESDAY, SEPTEMBER 11, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,
SUPERVISION, REGULATION AND INSURANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, at 10:30 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the subcommittee) presiding.

Present: Chairman St Germain, Representatives Barnard, Vento, Schumer, Wylie, McKinney, Wortley, and Roth.

Chairman ST GERMAIN. The subcommittee will come to order.

This morning we open hearings on the financial condition of our Nation's depository institutions. We hope to gain a better understanding of these conditions, and to see how they impact on the insuring funds. While the FDIC assures me that it can handle another Continental sized bank failure, and the FHLBB that its proposed agency will shore up FSLIC through the purchase of billions of dollars in troubled assets, I doubt that even the best laid plans can solve all the financial industry's problems.

When the thrift industry gleefully filled its coffers with $300 billion in deposits in 1982–83, the unfortunate result was too many thrifts incurring huge losses on real estate speculation, and hundreds with no real capital.

The banking industry's love affair with speculative investments and adversion to caution resulted in 79 bank failures last year—the worst year since the Depression. It is hardly cause for celebration that the FDIC has developed a contingency plan to handle upward of 200 bank failures.

The question begging to be asked is whether the current financial condition of our depository institutions is the result of general economic conditions and depository management risk taking, or whether the current financial condition can be traced to the operations of the Federal insuring funds. If the answer is the combustible combination of poor economy and lax lending controls, then the solution rests with better regulatory supervision rather than with deposit insurance reforms.

However, all too often the watchdogs, the Federal regulators, choose to look the other way when loan officers are reckless, when a Penn Square forwards $1 billion in bad loans to a Chicago compatriot. While the regulators are actively involved when it comes to lobbying for their wish lists, they halfheartedly enforce the laws Congress has enacted to promote the safety and soundness of our financial industry.

Today the regulators are back again. This time, however, they display a sincere concern about risktaking and have offered a number of proposals designed to wrest the industry from its devil-may-care ways. Some proposals, such as the qualified thrift test and the emergency interstate merger provisions of Garn-St Germain, have already been sanctioned by the committee and are included in H.R. 20 and H.R. 2707. It is my hope that these bills will soon receive favorable action by the Rules Committee.

Other proposals will be carefully considered by this committee, whether for added enforcement powers, for the authority to increase overall deposit insurance assessments, or for risk-based premiums and rebates.

But before we can weigh these various proposals, it is essential to know what we are dealing with. Just how badly are these reforms needed? What is the true worth of the insuring funds? Do the regulators need increased supervisory powers? Are existing hiring and pay levels for examiners realistic?

I believe that improved Federal supervision, healthy insurance funds, and an industrywide commitment to conscientious management can be achieved. Already improvements are being made. The FDIC reports that 217 banks were taken off its troubled list last year. The FHLBB asserts that one-third of the thrifts are running in the black, and the NCUA says that federally chartered credit unions remain strong, with only 13 out of almost 15,000 forced to close in 1984.

I am confident that this committee will find the testimony from the regulators, trade group representatives and academics who will be appearing in the weeks ahead to be exceptionally beneficial and helpful as we wrestle with the problems that confront us.

At this time I will call on Mr. Wylie.

Mr. Wylie. Thank you, very much, Mr. Chairman.

Mr. Chairman, may I begin by commending you for initiating what I consider to be perhaps as important a set of hearings that this committee has conducted in recent years. Our review of the financial condition of depository institutions and their insuring agencies, together with our action on the various proposals to reform our system of deposit insurance, should lead us in the direction of a stronger, more stable financial system that is responsive to the needs of the American public.

It has long been my opinion that Congress ought to give special consideration to the advice and counsel of those Federal regulators who supervise our Nation's depository institutions. They are the ones directly on the firing line to ensure the safe and sound operation of our financial system. We are fortunate indeed to have distinguished and high-caliber individuals in charge.

Having said that, Mr. Chairman, our Nation's financial regulators have all admonished Congress to act promptly on a variety of pending issues, including reform of our deposit insurance system. FDIC Chairman Bill Isaac has stated correctly that revolutionary changes are now occurring in the financial services industry and that there is no question about whether change will or should continue, but rather how to ensure that the financial structure that eventually results will best serve the public interest.

Federal Home Loan Bank Board Chairman Ed Gray has stressed that deposit insurance reform is the single most important issue that this committee can address.

Finally, Federal Reserve Board Chairman Paul Volcker has long warned Congress that we are at a crucial point in history as far as these issues are concerned and has pleaded with Congress to act to avoid the evolution of our financial system in a haphazard and potentially dangerous way.

Mr. Chairman, the bills you and I introduced at the request of the agencies can serve as an important foundation strengthening our financial system. Obviously, these proposals will not be the end result once this committee has worked its will, but they are a good beginning, as I have stated.

There is much in one or both of the agencies' proposals which should be commended, including expanded oversight and enforcement powers and the introduction of a risk-based assessment system on a limited scale. In a day and age when we are reminded daily of the faults of Government regulation and the limits of Government assistance, we also must look for ways to instill greater market discipline into our system and the hearings in the days ahead should provide quite useful in that regard, recognizing of course that the Federal Government does have a legitimate role to play in maintaining financial stability.

In closing, Mr. Chairman, I must commend you again for your leadership in convening these timely hearings. Given some of the events of recent months, we are very mindful of the simple fact that a sound financial industry cannot exist without public confidence. I am sure that our consideration of the proposals set forth by the deposit insurance agencies will lead us in the direction of continuing to provide a Federal Deposit Insurance Program that will retain that confidence. I genuinely look forward to working together closely with you and the other members of this committee to attain that goal.

Thank you very much.

Chairman **St Germain**. I thank you, Mr. Wylie. Thank you for your kind remarks.

At this point, I recognize the gentleman from Connecticut, who asked to be recognized for an opening statement.

Mr. **McKinney**. Mr. Chairman, I will be very brief.

I would not even suggest where this committee go, nor pre-guess any of its members, but I would simply say that I agree that the condition of the depositor insurance agencies is one of the greatest concerns we have. I violently disagreed with Chairman Isaac when he said the Continental Illinois collapse had not cost the taxpayers anything. In fact, the increase in FDIC and FSLIC premiums cost every individual American who does banking business enormous sums in fees and costs that he has to incur to maintain a policy.

There are those who will suggest that FDIC and FSLIC should be made in fact the same agency. I can't possibly imagine what they think they would be achieving, because it seems to me that the reason we are in the trouble we are in now, besides economic factors, with the savings institutions in this country, is that the regulatory agencies have been swamped, and to further bury the problems of the thrift industry in a massive depository insurance program, I cannot see.

The other thing I hope we will address is why in God's name is the United States of America and the U.S. taxpayers in fact insuring thrift institutions with the full faith and credit of the U.S. Government in States where the legislatures have gone absolutely mad. We are in fact putting our citizens' in Rhode Island, Connecticut, and Ohio money behind institutions in States such as California and Texas where the sky is the limit. It is go, go, go, let's buy a jet plane, a Mercedes, a Rolls Royce, and the hell with both the taxpayers and the depositories.

And perhaps as we are looking at that, we ought to turn around and ask ourselves the question, really is $100,000 too much? Does it take away the fiduciary responsibilities of the institution and does it take away the necessity for the consumer to really take a look, a long, hard look at in fact what the institution is like?

So obviously that ends us at the area of risk related, banking practices related, insurance premiums.

Thank you, Mr. Chairman.

Chairman **St Germain**. Thank you, Mr. McKinney.

If there is no one else who wishes to be recognized at this point, we will call upon the panel. Our first witness is William Taylor, Director of the Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System.

Mr. Taylor, we will put your prepared statement in the record and you may proceed.

STATEMENT OF WILLIAM TAYLOR, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. **Taylor**. Thank you, Mr. Chairman.

I appreciate the opportunity to appear before this subcommittee to discuss the financial condition of the institutions under the supervision of the Federal Reserve System. Although there are a number of financial institutions that continue to face a variety of difficulties, I feel the condition of banks in the country has improved. Clearly the problems in the farm, energy, international, and shipping sectors continue to provide the banking business with loan portfolio difficulties. We are not unmindful of the growing real estate difficulties that are highlighted in certain parts of the country. And, of course, the number of problem banks and failed banks continues at a high level.

Despite these difficulties, I think we should not lose account of the ability that the System has demonstrated in dealing with these problems and, in fact, we should pay attention to the fact that the majority of the banks in the country are indeed profitable, have good asset quality, sound operations and serve the public well.

If I could turn to the capital position of bank holding companies, I would indicate that it has improved in recent years in response to market pressures and hopefully improved as a result of our encouragement to strengthen resources in the face of increasing difficulties. A supervisor is always reluctant to indicate that banks or banking itself is overcapitalized, and so my view is that while encouraged by recent increases, I would hope it is more of a trend than an accomplishment.

Obviously, the level of required capital is related to the level of asset quality. This bank condition has clearly declined in recent years due to recessions, and in large part, to a fundamental change, or if you will, a decline in the assistance provided to the troubled borrower by inflation.

We are presently reviewing at our agency the manner in which we can, over and above the existing capital minimums, present a program that will require higher capital standards for those banks with greater risk profiles and a system that will increase the incentive to liquify the balance sheets of the banks.

With respect to earnings in the banking system, they have been fairly lackluster in recent years. Probably it is good to note that in many parts of the country bank earnings have been doing quite well.

With respect to bank liquidity, while several indicators of bank liquidity exist, this concept is often difficult to measure and the structure of liabilities, as well as assets must be considered. Recent reporting changes have helped. These figures do not, however, address directly the extent to which banks have matched the maturities of their assets and liabilities or the ability of banks to raise additional funds when trouble appears.

I would like to turn to a view of the statistics as relates to problem State member banks. As of June 30, 1985, there were 64 State member banks with composite ratings of 4 or 5 under the uniform interagency rating system. These 64 banks had total assets of $3.9 billion. As of June 30, there were 251 bank holding companies with composite 4 or 5 ratings under the bank holding company rating system. These 251 companies had total assets of $153 billion.

The number of problem banks and bank holding companies under Board supervision is larger than we would normally expect at this stage of the economic cycle. As discussed in my prepared testimony, the distinguishing feature of the current business cycle is that energy and agricultural sectors of the economy, have not improved as much as the overall economy and many private sector LDC loans continue to be problematical.

Domestic agriculture in particular has been deteriorating since 1980. Problems in agriculture are inevitably transmitted to farm banks which previously had very strong records of profitability.

As to actions being taken in response to the trend in the number of problem institutions, the Federal Reserve System has undertaken a comprehensive review of the supervision of State member banks and bank holding companies. Teams comprised of Federal Reserve bank and Board staff are reviewing the supervisory methodology and analytic techniques and have made proposals designed to enhance our effectiveness. A number of these initiatives have been adopted or are under active review. Principal components are as follows:

Instituting measures to strengthen the surveillance function;

Improving the communications of examination findings, including the format of the the written report of examination and the oral presentation to boards of directors;

Strengthening of prudential standards to help prevent problems;

Stressing the continuing importance of maintaining adequate capital and appropriate loan loss reserves;

Increasing the frequency and scope of the onsite examinations;

Upgrading coordination and cooperation with other banking supervisory agencies, both State and Federal, to improve efficiency and resource utilization; and

Sharpening the analytic approach to deal with issues such as bank holding company funding and liquidity, risk and leverage considerations in nonbanking activities.

I think, in summary, we are trying to structure a program that will make full use of modern technology with strong emphasis on the basics of good supervision.

Although we seek ways to strengthen our abilities to uncover difficulties at an earlier stage, thereby enhancing the chance for successful recovery, we would like to think that the rigor of our supervision has indeed been consistent throughout the period. While it seems essential that we make every effort to improve, we must be careful not to overreact. The goal of our business is that of wise selection among unhappy choices, something that must be done with great care.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Taylor, on behalf of the Board of Governors cf the Federal Reserve System, follows:]

STATEMENT BY WILLIAM TAYLOR, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS

I appreciate the opportunity to appear before this Subcommittee to discuss the financial condition of the institutions under the supervision of the Federal Reserve. As indicated by the data provided in the text of this testimony, there are a number of financial institutions that continue to experience a variety of difficulties. Problems in the farm, energy, international and shipping sectors are evident, and the number of bank failures and problem banks remains high by historical standards. On the positive side there has been an improvement in capital ratios (especially of larger banks) and the majority of the banks are profitable, have good asset quality and sound operations. The Subcommittee may wish to refer to related data previously provided on state member banks and bank holding companies in response to Chairman St Germain's letter of August 1, 1985. I would now like to address the specific questions raised in your letter of September 3.

Question 1 - Capital

After declining steadily during the 1970s, bank capital ratios have increased in recent years. Improvement is apparent throughout the range of institutions, as state member banks and bank holding companies have shown higher capital ratios during each of the past four years. This upward trend is also evident when capital is adjusted for classified assets and standby letters of credit.

From 1980 to 1984, the ratio of equity and loan loss reserves to total assets has risen from 5.37 percent to 6.15 percent for all state member banks, and from 5.30 percent to 6.33 percent for all bank holding companies with assets above $100 million. These increases are largely attributable to higher levels of capital at institutions with assets above $1 billion. Capital ratios at smaller state member banks have remained about level during the 1980s, while bank holding companies below $1 billion in assets have shown moderately improved ratios.

In addition to the calculation of capital ratios, the evaluation of capital adequacy must also take into consideration the quality of assets and the level of off-balance sheet risk. While classified assets have risen significantly at state member banks since 1980, capital ratios adjusted for classified assets still show increases for all size classes of state member banks and bank holding companies. If standby letters of credit were to be added to total assets in computing capital ratios, the results would still show an increasing trend.

Multinational banking institutions have also exhibited improvement in the ratio of equity and loan loss reserves to total assets in recent years. Capital ratios for these banks have risen since 1980, and are at their highest levels since the early 1970s, even though the capital ratios of these large banks are generally below levels of smaller institutions. Improvement is also evident in capital ratios adjusted for classified assets and for standby letters of credit. One is less sanguine about the improvement in large bank capital ratios when capital is measured against loans or risk assets.

One major reason for increased levels of bank and holding company capital has been the adoption of capital adequacy guidelines in December 1981. These guidelines established minimum capital levels and have continued to provide state member banks and bank holding companies with targets or objectives to be reached over time. Recent amendments to the guidelines, in conjunction with the capital maintenance regulations of the OCC and the FDIC, raised the minimum guidelines for large banking organizations and established uniform minimum capital levels for all federally supervised banking organizations.

Bank and bank holding company capital is not deemed to be adequate simply because an organization meets the minimum capital requirements. Banking organizations whose operations involve higher than normal degrees of risk are expected to hold additional capital. Areas which merit particular attention in analyzing risk profiles are the loan and investment portfolios, the level of liquid assets in relation to total assets, the volume and nature of all off-balance sheet risk (particularly standby letters of credit), the level and specific character of intangible assets, and the extent and nature of all nonbanking activities. Institutions which are deemed to have inadequate levels of capital are required to submit an acceptable plan for achieving compliance and may be subject to appropriate supervisory and regulatory actions.

Are capital levels adequate? From a supervisor's viewpoint it is hard to imagine that a bank could be too well capitalized and it is even more difficult to determine what amount of capital is adequate to cover the ever changing risk profiles. And so the best answer seems to be that capital levels are stronger than they have been but are not at such a level that would cause us to moderate our encouragement to the banks for continued improvement.

Question 2 - Asset Quality

Asset quality is generally sensitive to national and international economic conditions. As the financial strength of certain borrowers deteriorates during periods of recession, their ability to satisfy their loan obligations is impaired. After a lag, banks are forced to write off an increasing percentage of loans due to nonpayment.

The typical pattern has been for net charge-offs to increase sharply during a recession, to continue to increase in the year after a recession, then to decline as economic conditions improve. The present period has not conformed to this general pattern. Credit quality, as measured by the charge-off ratio, has not improved during the present economic recovery.

Part of the explanation for this phenomenon has to do with the particular conditions of the past few years which have adversely affected credit quality for the nation's businesses. These include back-to-back recessions and the transition to a period of lower inflation and inflationary expectations.

In addition, part of the explanation concerns problems endemic to particular sectors: agriculture, international, energy and real estate. The obvious problems in the agricultural and energy sectors, the difficulties that less-developed countries (LDCs) have had repaying debt, and the overbuilding in certain sectors of the real estate business, have all contributed to a worsening of credit quality problems in recent years. In contrast, credits in the agricultural, energy and international sectors were relatively unaffected by the 1973-74 recession (although there were some international credit problems in industrialized countries). In the late 1970s and early 1980s these credits were not considered major problem areas. Although the real estate industry suffered setbacks in the mid-1970s, by the end of the decade (helped by the rapid inflation of the period) it too was faring relatively well.

Since 1982 credit quality has deteriorated more at the largest and smallest banks than at those of moderate size. Data for all insured commercial banks since 1982 indicate that the greatest increase in the ratio of net charge-offs to equity and loan-loss reserves has been for banks with over $1 billion in assets and for those with less than $300 million in assets. For banks over $1 billion, net charge-offs to equity and reserves has gone from 7.93 percent in 1982 to 10.25 percent in 1984; banks below

$300 million have also shown a significant increase during this period, with the ratio going from 5.58 percent to 7.04 percent. For state member banks, the ratio of classified assets to total assets also has increased sharply since 1982 for banks in these two size groups, whereas for banks with assets of $300 million to $1 billion, this ratio has actually declined.

Off-balance sheet activity is growing rapidly and the risks associated with these activities need to be closely monitored. For the 25 largest bank holding companies, which are responsible for the preponderance of these off-balance sheet items, standby letters of credit have approximately tripled since the beginning of the decade. During 1984, the nation's 100 top issuers increased their standby letters of credit by 25 percent. Other off-balance sheet instruments, such as financial futures, forwards and options, interest rate swaps, etc., have also increased.

Much of the off-balance sheet activity is a response to heightened demands for more sophisticated financial services generated by such factors as improved technology, the increasing integration of international financial markets, and more volatile interest rates. Pressures for stronger capital ratios have to some degree contributed to the growth of off-balance sheet business. By creating contingent rather than direct obligations, banks generate fee income but avoid increasing their reported assets. When measured relative to assets, leverage is reduced and profitability increased.

Although off-balance sheet activities are not now quantitatively included in the capital guidelines of the Federal Reseve Board (FRB), its policy statement on capital adequacy states that these items will be considered in assessing a bank's capital adequacy. The FRB is currently studying methods whereby certain items (e.g., standby letters of credit) would be specifically included in the calculation of bank capital ratios.

Question 3 - Earnings

In 1984, state member banks earned a 0.62 percent return on year-end assets (ROA) and a 11.58 percent return on year-end equity (ROE). During the same period, all bank holding companies (BHCs) with assets above $100 million earned returns of 0.55 percent and 9.97 percent, respectively.

In terms of the period since 1970, the ROAs and ROEs achieved by state member banks in 1984 can be considered only fair. At 0.62 percent, the 1984 ROA figure is consistent with the range achieved throughout the 1980s, above the range achieved throughout the second half of the 1970s (during which ROA never exceeded 0.58 percent), but below the levels recorded during the first half of the 1970s. (In 1970 and 1971, ROA for state member banks was 0.73 percent and 0.71 percent, respectively.)

ROE for state member banks in 1984, at 11.58 percent, equalled 1983's mark and remained well within the fairly narrow band of 10.04 percent (1976) to 12.87 percent (1980) registered from 1970 to 1984.

In 1984, state member banks within the smaller size classes once again outperformed the larger banks with assets of $1 billion and over in terms of ROA: 0.77 percent for banks smaller than $300 million; 0.88 percent for banks between $300 million and $1 billion; and 0.59 percent for banks over $1 billion. In a reversal of past years, banks in the middle size class outstripped those in the smallest one, presumably due to the performance of agricultural loans which are concentrated in the smallest bank size class.

ROE, like ROA, was generally true to form in 1984. The largest banks, due to their greater use of leverage, compensated somewhat for lower ROAs. At 11.96 percent, ROE for the $1 billion and over banks surpassed the 9.43 percent mark for the under $300 million banks, but fell short of the 12.36 percent mark for the $300 million to $1 billion banks. In short, 1984 was not a premier year for bank earnings, nor have the recent several years been particularly robust.

Question 4 - Bank Liquidity

While several indicators of bank liquidity exist, this concept is often difficult to measure, and the structure of liabilities, as well as assets, must be considered. Recent reporting changes provide more information about the frequency with which banks can reprice their assets and liabilities; that data base is useful for evaluating the exposure of banks to interest rate movements. These figures, however, do not address directly the extent to which banks have matched the maturities of their assets and liabilities or the ability of the banks to raise additional funds when needed.

As clearly demonstrated in recent years, the liquidity of any financial institution rests heavily on depositor confidence. Funds can quickly flow out of an institution if confidence wanes. Perceived liquidity provided by large amounts of "short-term" loans may also be misleading if, as with some customers, the loans must constantly be renewed. And, of course, it remains true that banks that depend heavily on the professional financial markets for funding remain more vulnerable to liquidity problems than banks with a broader base of consumer and business deposits.

These data show that purchased funds (large CDs, foreign office deposits, etc.) as a percentage of total assets of state member banks increased each year from

1976 through 1982 and have declined in 1983 and 1984. Large banks were, of course, much more dependent on these funds than smaller banks.

The volume of brokered deposits has been collected only since 1983 and is not significant, in aggregate, for state member banks. At year-end 1984 these deposits funded only 0.34 percent of the assets of all state member banks and a much smaller share for banks with assets below $1 billion. Moreover, the use of these deposits has declined since year-end 1983, when state members funded 0.43 percent of their assets with brokered deposits.

While these deposits are significant for a few state member banks, the amounts involved in these cases are relatively small. Only 12 state member banks held more than $20 million in brokered deposits at year-end 1984 and virtually all of them were major banking institutions. Several of the relatively heavy users of brokered deposits were Delaware subsidiaries of major New York City banks, which are prevented by law from dealing with local customers.

Question 5 - Problem Institutions

As of June 30, 1985, there were 64 state member banks with composite ratings of 4 or 5 under the Uniform Interagency Rating System. These 64 banks had total assets of $3.9 billion.

As of June 30, 1985, there were 251 bank holding companies with composite 4 or 5 ratings under the Bank Holding Company Rating System. These 251 companies had total assets of $153 billion.

The number of problem banks and bank holding companies under Board supervision is larger than we would normally expect at this stage of the economic cycle. As discussed in the response to question two, the distinguishing feature for the current business cycle is that the energy and agricultural sectors of the economy have not improved as much as the overall economy and many private sector LDC loans continue problematical. Domestic agriculture, in particular, has been deteriorating since 1980. Problems in agriculture are inevitably transmitted to farm banks, which previously had strong records of profitability.

Of the 64 state member banks rated composite 4 or 5, 19 are farm banks. All but one of these farm banks have become problem institutions since 1983. It is also noted that 40 of the 145 banks with composite 3 ratings are farm banks. Thus, nearly 30 percent of the financial institutions subject to special supervisory attention are banks with farm loan concentrations. The increase in the number of problem banks in recent years can be related to a variety of factors including the effects of two recessions, a shift in inflationary expectations, increased competition brought on at least in part by interest rate deregulation, poor business judgment and, in some cases, misuse of the public trust, such as fraud, insider abuse and self dealing.

Although the increase in the number of problem banks has caused us to seek ways to strengthen our ability to uncover difficulties at an earlier stage, thereby increasing the chances of successful recovery, we would like to think that the rigor of our supervision has been consistent throughout the period. While it seems essential that we make every effort to improve our supervision of banks, we must be careful not to overreact. Ours is a business of wise selection among unhappy choices. Something that must be done with great care.

As to actions being taken in response to the trend in the number of problem institutions, the Federal Reserve System has undertaken a comprehensive review of the supervision of state member banks and bank holding companies. Teams comprised of Reserve Bank and Board staff are reviewing the supervisory methodology and analytic techniques and have made proposals designed to enhance our effectiveness. A number of these initiatives have been adopted or are under active review. The principal components of this effort are as follows:

- Instituting measures to strengthen the surveillance function in order to identify more promptly emerging supervisory problems.
- Improving the communication of examination findings, including the format of the written report of examination and the oral presentations to boards of directors.
- Strengthening of prudential standards to help prevent problems (leveraging, liquidity, dividend policy).
- Stressing the continuing importance of maintaining adequate capital and of holding appropriate loan loss reserves.
- Increasing the frequency and scope of the on-site examinations.
- Upgrading coordination and cooperation with other banking supervisory agencies, both state and federal, to improve efficiency and resource utilization.
- Sharpening the analytic approach to deal with issues such as bank holding company funding and liquidity, risk and leverage considerations in nonbank activities, etc.
- Increasing staff and enhancing training.

Question 6 - History and Prospective on Emergency Actions

The Bank Holding Company Act and the Bank Merger Act contain a number of special provisions to authorize expedited action on mergers and acquisitions in situations involving troubled banks. These statutes allow the Federal Reserve to shorten or suspend the comment period and eliminate the Federal Register publication requirement for applications designed to prevent the probable failure of a bank or a bank holding company. Thus, the Board, at the request of the financial institution's chartering authority, can permit the acquisition of a troubled institution either immediately or on the fifth calendar day after the expiration of the comment period, depending upon the severity of the financial institution's problems.

So far this year, the System has approved twelve bank holding company applications involving troubled banks. Also, there have been in 1985 three emergency actions processed under the Change in Bank Control Act in order to prevent the probable failure of bank holding companies. This number compares to 16 expedited actions in 1984 and 14 in 1983. At this stage of the cycle we would normally expect the number of such actions to decline. However, continued difficulties in certain sectors of bank lending must be factored into any judgment about the number of such actions that might be necessary.

Chairman St Germain. Thank you.

Now we will hear from Robert Shumway, Director, Division of Bank Supervision for the Federal Deposit Insurance Corporation. We will put your entire statement in the record. You may proceed.

STATEMENT OF ROBERT V. SHUMWAY, DIRECTOR, DIVISION OF BANK SUPERVISION, ON BEHALF OF THE FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Shumway. Thank you.

On behalf of the FDIC, I am pleased to have the opportunity to testify at this series of hearings evaluating the present system of Federal deposit insurance.

My purpose here today is to give a brief overview of the financial condition of depository institutions under the purview of the FDIC. It is well known that we are faced with problems in the financial industry today. More than 1,000 banks are currently on our problem bank list. Since the beginnning of 1981, the FDIC has handled over 250 bank failures totaling over $30 billion in assets, excluding Continental Illinois. To put those numbers into perspective, during the FDIC's previous 47 years, failures totaled only $9 billion in assets. The problems in the thrift industry are still serious, while weaknesses in agriculture, energy, real estate, and the international debt arena continue to plague the banking industry.

But there is good news in all of this. The good news is that for the most part the problems have been handled well. The vast majority of our banks are in remarkably good shape. While numbers of problem institutions are at historically high levels, they still constitute a small percentage of the total and the failure rate of about one-half of 1 percent per year is still low.

Earnings have held up reasonably well despite large loan losses and banks, particularly the larger ones, have added substantial sums to their capital base. Overall, the banking system has shown a remarkable resilience by demonstrating that innovation and ingenuity are the keys to success in today's dynamic environment.

After years of relative stability, depository institutions are learning that recognition of and adaption to marketplace changes are essential elements for survival, growth and profitability. The forces behind these changes include unprecedented economic volatility, deregulation, technological advancements, and changing consumer demands. All of this has led to a more competitive environment for banks.

Not long ago we considered banks special because of the unique services they provided. This is no longer true. The marketplace has developed such a variety of product substitutes that there is not one product that is unique to banking any more. For this reason, the FDIC has supported expanded banking powers. It is our belief that the American consumer would benefit from the availability of a broader range of financial services at more competitive prices.

In assessing the condition of the banking industry as it stands today, several measures should be used. As insurer and supervisor of almost 15,000 banks, the FDIC has always had a critical interest in bank capital levels. In March of this year, the FDIC, the Comptroller of the Currency, and the Federal Reserve jointly moved to define bank capital and set a higher minimum acceptable capital level for banks. Banks which do not maintain the minimums will be subject to supervisory measures such as enforcement actions and restrictions of expansion proposals.

Those banks that are judged to present more than a normal degree of risk or greater than a normal volume of criticized assets, are being required to maintain capital at an appropriate level higher than the basic minimum.

While these capital requirements do not take into account off-balance sheet liabilities, and exposures arising from banks engaged in nontraditional activities, we are looking closely at the risks in these areas as they grow in size and potential impact. Such liabilities and exposures now total billions of dollars in many of the Nation's relatively large banking organizations, and often represent a sizable percentage of total assets.

It is our view that bank supervision must provide for a closer scrutiny of these risks, including means by which these risks can be factored into capital standards.

Despite the adverse trends reflected in loan loss reserves and asset quality, commercial banks have been able to maintain reasonably satisfactory earning ratios. The same cannot be said for mutual savings banks. Many of the savings banks are still suffering from asset liability mismatches caused by highly volatile interest rates and portfolios of long-term, fixed-rate assets. Most saving banks have now turned profitable but our projections show that interest rates will have to stay low and remain stable for an extended period before many of these institutions regain a reasonable level of profitability.

With regard to liquidity, traditional measures seem to indicate that liquidity may be acceptable but we caution that there is no single benchmark currently used that can capture the many facets of liquidity. Banks, particularly the larger ones that are actively involved in the purchased funds market, have developed a host of new products and operating procedures that make any measurements of liquidity difficult. Indeed, market confidence, which may be correlated to asset quality, capital, and earnings, may actually be the most important factor.

At this point, Mr. Chairman, I would be remiss if I did not mention the subject of brokered deposits. The ability of deposit brokers to place fully insured investments has rapidly become one of the most serious problems facing the FDIC today. We believe current broker funding practices have a very real potential to erode the deposit insurance system because insured institutions, can significantly expand or alter their very nature in a few business days. Normal banks supervisory and risk control techniques can thus be rendered ineffective.

All too often we have found that the weakest banks are the worst abusers of this market and their failures have cost us millions of dollars. Frankly, we do not think it is proper to leverage upon Federal guarantee of deposits for what is essentially yield seeking funds.

With regard to the number of FDIC insured problem institutions, I think it is important to emphasize that most problem banks do not fail. Their managements are usually successful in overcoming the bank's particular difficulties long before there is any real danger of failure.

We have found that there is a correlation between an unfavorable economic environment and an increase in the number of problem banks. I do not need to emphasize the severe strains in some cases and realignments which have recently occurred in some sectors of the economy. However, it would be simplistic to dwell on this as the only direct cause and effect relationship. The fact is that banks which are poorly managed and marginally operated are the first to be adversely impacted when external situations become unfavorable. That is why we are so concerned with the management factor. Good management can and usually does make the difference between a bank's success and failure.

Thank you.

Chairman **St Germain**. Thank you, Mr. Shumway.

[The prepared statement of Mr. Shumway, on behalf of the Federal Deposit Insurance Corporation, follows:]

A PRESENTATION ON

THE FINANCIAL CONDITION OF FDIC-INSURED INSTITUTIONS

TO THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

BY

ROBERT V. SHUMWAY
DIRECTOR
DIVISION OF BANK SUPERVISION
FEDERAL DEPOSIT INSURANCE CORPORATION

10 a.m.
September 11, 1985
Room 2128, Rayburn House Office Building
Washington, D.C.

Good morning, Mr. Chairman. On behalf of the FDIC, I am pleased to have the opportunity to testify at this series of hearings evaluating the present system of Federal deposit insurance. Over the past several weeks my staff compiled and provided to your Subcommittee a series of statistical tables which I trust is responsive to your request and will be helpful to you throughout these hearings.

My purpose here today is to give a brief overview of the financial condition of depository institutions under the purview of the FDIC. It is well-known that we are faced with problems in the financial industry today. More than 1,000 banks are currently on our problem bank list. Since the beginning of 1981, the FDIC has handled over 250 bank failures totaling over $30 billion in assets, excluding Continental Illinois. To put those numbers into perspective, during the FDIC's previous 47 years, failures totaled only $9 billion in assets. The problems in the thrift industry are still serious, while weakness in agriculture, energy, real estate and the international debt arena continue to plague the banking industry.

But there is good news in all this. The good news is that for the most part the problems have been handled well. The vast majority of our banks are in remarkably good shape. While numbers of problem institutions are at historically high levels, they still constitute a small percentage of the total and the failure rate of about 1/2 of one percent per year is still far below that of any other industry. Earnings have held up reasonably well despite large loan losses and banks, particularly the larger ones, have added substantial sums to their capital base. In short, the banking system has shown a remarkable resilience by demonstrating that innovation and ingenuity are the keys to success in today's dynamic environment.

A CHANGING ENVIRONMENT

Any discussion involving the condition of the banking system must naturally begin with a description of the banking environment. After decades of relative stability, depository institutions are learning that recognition and adaption to marketplace changes are essential elements for survival, growth and profitability. Over the last five years alone the banking system has had to endure two back-to-back recessions, double digit inflation, unprecedented interest rate volatility, removal of most interest rate caps, erosion of geographic and product market barriers, a major technological revolution and demographic shifts. What's more, the economy, while rebounding strongly from a severe recession, has recovered much more unevenly than in any previous recovery. As a result, major sectors of the economy are still suffering from a recession hangover, and indications are that those sectors will continue to lag other sectors over the short run.

The forces behind these changes are many and quite diverse. One major force that often gets overlooked is the consumer. Consumers today have different financial needs than ever before. They have become more sophisticated and increasingly aware of the many financial products available to them. When inflation rates soared to double digit levels, consumers recognized that they could no longer afford to deposit funds in nonearning or low yielding bank accounts. Instead, they demanded new financial products that gave them reasonable yields, more convenient access to cash assets and safety. Consumers today are now less concerned about the type of institution providing the service than they are about the quality of the service provided and the returns they receive.

In response to these demands, banks and nonbanks alike took up the challenge. Supported by major technological innovations, new products were developed that reshaped the financial service marketplace. In some instances, consumer needs were satisfied by skirting geographic and product barriers and by exploiting loopholes in laws that were never designed to address electronic banking. Computers provided the means to transform product design to such an extent that banks and other financial service providers are able to offer new products and services more quickly and cheaply than anyone could have imagined over 50 years ago.

Deregulation has also been a major force in reshaping the financial system. Banks now pay market rates for deposits thus benefiting countless bank and thrift customers. But with those benefits comes an enormous cost to the paying institution. Geographic and market restrictions are increasingly evaded, and while some product deregulation has taken place, it has been permitted primarily for the thrifts and nonbanks.

Commercial banks are facing increased competition from a variety of sources. Not long ago we considered banks special because of the unique services they provided. This is no longer true. The marketplace has developed such a variety of product substitutes that there is not one product that is unique to banking anymore. For this reason commercial banks can no longer be viewed in a vacuum.

In response to increased competition, the banking industry has continued to seek expanded powers to deregulate the asset side of the balance sheet. While they wait, we have seen thrifts, credit unions and even investment banking firms offer a host of services including federally insured deposits accessible by check or other transfer mechanisms, once considered the unique province of commercial banks. Moreover, thrifts have more liberal authorities regarding investment and geographic expansion than do commercial banks or their holding companies, yet they have less strict capitalization, accounting and disclosure requirements. We see department stores expanding their financial centers and investment bankers targeting businesses for cash management accounts and loans. Realtors are selling mortgages while gas stations and grocery stores are installing ATMs and charging banks when their customers use them.

I could go on, Mr. Chairman, but the point is that if banks are to compete effectively in this new dynamic environment, they must be given the proper tools to do so. For this reason, the FDIC has long supported expanded bank powers. It is our belief that the expansion of bank powers would enhance the ability of banks to respond to the changing needs of the marketplace. If banks could offer a wide range of financial services, the American consumer would have a broader range of convenient financial services available at more competitive prices. Expansion of product and geographic powers would have the additional benefit of strengthening our financial system by allowing banks to diversify their activities so that they are less vulnerable to economic ups and downs. Like it or not, economic volatility, deregulation, technological advancements and changing consumer demands are the forces that will shape tomorrow's financial system. Our job is to fully understand these forces so that we can respond in a way that will foster a stonger financial system.

RECESSION AND RECOVERY -- ITS IMPACT

This brings me to the more specific questions detailed in your letter to the FDIC. Since I have been discussing the environmental changes facing banks today, let me begin by addressing the sensitivity of asset quality to economic conditions and the effect successive periods of recession and recovery have had on the banking system.

Any attempt to identify the causes or reasons for the increase in the number of problem and failed banks must logically begin with an understanding of the overall economic environment. Banks, by their very nature as suppliers of funds to American business, have historically mirrored the economy (either local, national or international). I do not need to tell you of the severe strains, and, in some cases, realignments, which have recently occurred in some sectors of our economy. Banks which serve those industries are also experiencing some difficulty.

Over the years, the FDIC has undertaken several studies designed to look at the correlation between economic conditions and condition of the banking system. Because of the numerous variables involved in a large, diverse economy such as ours, there are few simple answers. For example, it comes as little surprise that there is a correlation between general economic conditions and the asset quality of banks. It is also not surprising that as a recession becomes more protracted, increasing numbers of borrowers are forced to default, lowering bank profits and ultimately leading to higher failure rates.

But there are considerable time lags between the onset of a recession, deterioration of asset quality and increased bank failure rates. Internal studies have concluded that loan losses appear to lag changes in the economy by about three-quarters. Not surprisingly, the number of bank failures also increased significantly after the two most severe post war recessions. For example, after the 1974-75 recession 14 banks in 1975 and 16 banks in 1976 failed. Since the 1981-82 recession, we have seen 42 banks fail in 1982, 48 in 1983, 79 in 1984 and an additional 77 so far this year. Moreover, we are projecting that the failure rate will exceed 100 this year and next.

Obviously, the difference in failures between the two recessions is quite startling. But, that difference cannot be fully explained by merely comparing the severity or duration of the two recessions. While we have been able to establish a statistical relationship between failures and such macroeconomic variables as real GNP growth, unemployment rates, real interest rates and corporate debt burden, the relationship does not fully explain the huge disparity in failures. Other factors are undoubtedly involved.

One of those "other factors" may be the unevenness of this economic recovery. Although we are well into our third year of recovery, some industries and regions still lag far behind. Several factors may be responsible for this. The high value of the dollar relative to other currencies has significantly hurt export trade, and those industries which rely heavily on trade. Another factor has been the increased foreign competition against our more labor intensive industries, where lower labor costs give foreign firms a distinct advantage. Still other industrial problems are related to a secular decline in the demand of certain products. Steel and energy are examples of this, where a softening of world demand has resulted in chronic problems for segments of these industries. The segments of the economy that have given us, as bank regulators, the most concern recently include agriculture, energy and real estate industries, together with problems in the international arena. Because of the serious nature of these problems and their impact on the banking system, I would like to address each area individually so that you will better understand the nature of our concerns.

Agriculture

First is agriculture. Problems in the agricultural sector have been well-publicized over the past several months and are still cause for great concern. Many of the problems that we see today originated in the 1970s when farmers anticipated continued export growth, increasing commodity prices and rising land values. In response, many farmers borrowed heavily to finance major expansion programs. Farm debt doubled from 1976 to 1981 while interest rates spiralled upward bringing on significantly higher debt servicing requirements. Unfortunately for those farmers, the expectations of the 1970s never materialized in the 1980s. First the double digit inflation of the 1970s was brought under control and dramatically reduced. Then exports, instead of rising, plunged drastically. Commodity prices stagnated while interest and production costs remained at very high levels. On the supply side, domestic price supports, tax incentives, and other subsidies to U.S. farmers have encouraged continual overproduction and contributed to price declines for agricultural products on world markets.

Demand growth has also been severely curtailed since 1980. First, it was curtailed by global recession in 1981 through 1983 and the dollar's appreciation, and then by the slow recovery of many European economies, the imposition of import restrictions among LDC debtors and the increased self-sufficiency of many developed trading partners of the United States.

As a result, land values began to decline and farmers, who had relied on rising values to support their operations, were forced to rely on cash flows that were insufficient to meet high debt service requirements. Presently neither land values nor cash flows will support the credit needs of many of our farmers.

The toll taken on U.S. banks by these developments has been significant, and it promises to mount. We have defined agricultural banks as those banks with 25 percent or more of their loan portfolios concentrated in agricultural loans.

Although it is estimated that such banks provide less than 25 percent of total farm credit, there are approximately 3,900 agricultural banks in this country, of which 3,300 are concentrated in a 16-state area. In addition, a number of large institutions have sizable agricultural loan portfolios which may not reach the 25 percent benchmark used to designate agricultural banks but are still directly impacted by problems in the farm economy.

The problems in the farm belt are real and indeed worrisome, but I must caution against an overreaction with regard to their overall impact on the banking system. Looking at the problem from another perspective, the total assets of all agricultural banks represent only about five percent of all domestic bank assets. Nevertheless, total farm credit advanced by all insured commercial banks approximates $50 billion. It is also likely that there is a substantial number of loans not specifically designated as farm credits which are probably either directly or indirectly tied to the health of the agriculture industry.

Agricultural banks have historically reflected higher capital ratios than non-agricultural banks. From 1980 through 1984 capital ratios for these banks increased from 9.3 to 9.8 percent. As of March 31, 1985, that ratio increased to 10.2 percent. The problems in those banks do not begin to appear, however, until the earnings and nonperforming loan ratios are analyzed.

Looking at averages, the earnings performance between agricultural and nonagricultural banks appears virtually identical. But, as so often is the case when averages are used, the numbers can be deceiving. Statistics now show that there is a sizable and growing percentage of farm banks experiencing breakeven earnings or worse. As a group, agricultural banks experienced sizable loan losses during 1984. But perhaps the most disturbing trend is the high and increasing level of nonperforming loans. In the first quarter of 1985, the percentage of banks showing nonperforming loan totals at five percent or more of total loans increased from 23 to 32 percent. This trend is most troubling because historically the first quarter has not been one where farm banks normally recognize or encounter loan problems.

Only seven agricultural banks failed in 1982, but 25 such banks failed during 1984 and 28 failed in the first half of 1985. Furthermore, the number of agricultural banks on the problem list more than tripled during the 24 months ended June 1985. These numbers are likely to grow further in the coming months as the structural change in U.S. farming and world agriculture markets continues. The bumper crop expected for U.S. farmers in 1985 may greatly intensify debt repayment problems in the near term as commodity prices and agricultural profits could be severely depressed if crop forecasts prove correct. Moreover, with already depressed food prices worldwide and the growth of food production outside the U.S. still far surpassing the growth of world demand, it is difficult to see how U.S. agriculture can escape a future of further consolidation.

Real Estate

In the real estate sector, declines in interest and inflation rates have kept the housing market at moderately strong levels since 1983. While demographic and other social trends broadly determine housing demands over the long run, effective short-term demands are predominately affected by housing affordability. Several factors influence affordability including housing prices, family income and, most importantly, mortgage interest rates. Since the end of 1982, housing affordability has increased primarily because of declining interest rates. As long as the interest rates remain within reasonable levels it is expected that the outlook for housing will remain relatively bright.

Despite the generally positive outlook for most real estate sectors there are some major areas of concern that will continue to have an adverse impact on the banking industry. To a large extent, the problems that exist in the real estate industry can be traced to those sectors of the economy that are not participating in the recovery.

I have already mentioned agriculture as an area where major problems exist. Following a decade of rapidly inflating land values, farm real estate prices have declined 20 to 30 percent in several farm belt states since 1981. While some analysts believe land prices have stabilized to a point where cash flows, based on current commodity prices, will support the values, there is concern that the large amounts of land on the market may result in a significant undershooting of land prices.

Further examples of weakness in the real estate industry can be seen in several other areas around the country. In many Southwestern States, where problems in the energy industry are prevalent, we see signs of serious overbuilding as a result of speculation on growth in the energy industry. Houston and parts of Dallas show very high commercial office and multifamily vacancy rates. Similar high vacancy rates are beginning to surface in other cities around the country which may indicate a major oversupply problem. Further indications of weakness in this industry and the potential impact on the banking industry will be watched closely by the FDIC.

Energy

Looking toward the energy sector, the slide in world energy prices that began in the recession year of 1981 has not yet been completed. On the supply side of the market, price competition has steadily intensified outside of OPEC. Even members of the cartel (especially debtors) have responded by shaving official OPEC prices and cheating on production quotas in order to preserve oil revenues. This in turn has added to the downward pressure on world prices.

Domestically, the deregulation of energy prices has also generated increased competition and the predictable result has been a strong growth of supply, declining prices and sharp increases in the number of failed energy firms.

On the demand side, energy conserving innovations in response to years of high and rising prices have vastly reduced energy usage per dollar of production throughout the world. As a result of this, the economic recovery of recent years has had a far less buoyant influence on oil and gas prices than previously. The growth of world demand in 1985 is two percent (per annum) behind

1984's slow pace, and the effects of conservation can be expected to persist for the foreseeable future.

The developments on both the demand and supply sides of energy markets suggest that a transition to lower real energy prices is still taking place. In world markets, Mexico has cut its price by $1.25 per barrel with OPEC poised either to follow or dissolve, and non-OPEC production has surged throughout the summer. Reacting to these events, the futures market now prices June 1986 crude oil deliveries (United States) at $26.34 per barrel -- a forecast of an additional $3 per barrel decline in oil prices. A significant domestic price recovery could emerge temporarily if the dollar's foreign exchange value greatly depreciates but the fundamentals suggest that a protracted period of lower energy prices is still to come.

As retrenchment and consolidation continue in the oil and gas sector, increasing numbers of energy lenders suffer losses. Several major Southwestern banks reported severe losses due to energy loans for the first quarter of 1985 and, with oil prices currently falling, concern has heightened over the prospect of a new round of deteriorating credit quality at these banks. Many loans originated since 1981 may become nonperforming if domestic prices reach the $22 to $23 per barrel range. The likelihood of further erosion in energy prices makes it probable that significant loan losses will reappear in the future.

International Debt

In the international arena we have seen deterioration in the overall credit quality of foreign loans which has had a negative effect on the asset quality of U.S. banks. The impact has been greatest for the largest banks. The 25 largest U.S. bank lenders account for almost 80 percent of all foreign loans held by U.S. banks, and a comparable share of problem foreign loans At the end of 1984, nonperforming foreign loans, which are defined as nonaccrual loans plus renegotiated debt, totaled $11.1 billion or 4.5 percent of all foreign loans outstanding. Loans 30 days or more past due but still accruing stood at $2.9 billion. In comparison, total nonperforming loans, both foreign and domestic, were $42.6 billion at year-end or 2.9 percent of consolidated total loans, and total past due loans were $39.1 billion. This represents a departure from past experience, when foreign loan credit quality was consistently better than that of domestic loans. The higher levels of subquality foreign loans have not as yet produced high levels of loan chargeoffs, but the trend of foreign loan credit quality is not encouraging.

Countries that have had external debt reschedulings owed a total of $94 billion to U.S. banks at the end of 1984. Sixty billion dollars of that amount was owed to the nine largest U.S. lenders. The problems of Latin American borrowers have been widely publicized. United States banks' aggregate exposure to those troubled borrowers is over $82 billion, which is roughly equal to the combined net worth of all U.S. banks lending overseas.

The deterioration in foreign asset quality has not been evenly distributed geographically, and its impact on bank balance sheets has not been evenly felt among different sized banks. The main area of concern remains Latin America, and the main victims of foreign loan problems are the large money center banks. Their overseas problems are mitigated somewhat by improved domestic asset quality and a strong U.S. economy. Also, the largest banks have had stronger growth in their net worth positions, owing to regulatory requirements for increased capital levels. Nevertheless, foreign loan problems, because of their effect on public confidence, represent a major threat to large U.S. banks today.

CONDITION OF THE BANKING SYSTEM

Now, I would like to discuss some basic industry ratios and statistics that will help describe our assessment of the banking system as it is today. The FDIC, in its role of insurer and supervisor of almost 15,000 banks, has consistently had a critical interest in the capitalization of the industry and the capital levels of individually insured institutions. Capital adequacy is an important consideration in providing depositor protection and in maintaining public confidence in the stability of the financial system. Importantly, it can absorb short-term losses and temporary fluctuations in income thereby providing continuity during economic downturns. When prudent capital standards are enforced, it can also play a major role in restraining imprudent risk-taking or excessive expansion efforts.

In 1981, the FDIC and other Federal bank regulatory agencies took an important step to increase capital in the system and adopted policy guidelines specifying minimum capital ratios for insured banks. We were pleased that this had an immediate impact -- the declining trend in equity capital (relative to bank assets) was halted, and an increase in the systemic level of capitalization was achieved in 1983.

In March of this year the FDIC, the Office of the Comptroller of the Currency and the Federal Reserve jointly moved to define bank capital and to set a higher minimum acceptable capital level for banks. This was aimed at increasing the system's total capitalization by about $6.3 billion. Banks which do not maintain the minimums will be subject to supervisory measures such as enforcement actions and restriction of expansion proposals. Those banks judged to present more than a normal degree of risk or with a greater than normal volume of criticized assets will be required to maintain capital ratios at an appropriate level higher than the established basic minimum.

Off-balance Sheet Activities

While these capital requirements do not take into account off-balance sheet liabilities and exposures arising from banks engaging in nontraditional activities, we are looking closely at risks in these areas as they grow in size and potential impact. Such liabilities and exposures now total billions of dollars in many of the Nation's relatively large banking organizations, and often represent a sizable percentage of total assets. Bank supervision must provide for a closer scrutiny of these risks, including means by which these risks can be factored into capital standards.

Earnings

Despite the adverse trends reflected in loan loss reserves -- classified assets and nonperforming loans, increased competition from nonbank financial institutions, historically high and volatile interest rates -- commercial banks have been able to maintain reasonably satisfactory earnings ratios throughout this difficult period. This is not to say that there has not been a decreasing trend -- there has. In fact, 1984 marked the fourth consecutive year where the basic earnings ratios of insured commercial banks declined. But overall, considering today's environment, commercial bank earnings have been encouraging.

The dropoff in 1984's performance was most pronounced in small banks. These institutions have been under pressure from both narrowing net interest margins and widening credit losses. On a brighter note, medium sized institutions registered year-to-year gains in profitability as their greater diversification enabled them to weather the aftermath of the recession better than their smaller counterparts. The largest institutions also would have shown improved profitability if it had not been for the adverse effect of the extraordinary Continental Illinois earnings loss.

The prospect for improved future earnings depends to a large extent on future loan losses. While net chargeoffs continued to increase in 1984, the rate of increase slowed. Past due loans declined in relative terms, while nonperforming assets increased for small and large banks. Thus, the credit quality picture remains mixed.

Unlike the commercial banks, mutual savings banks have been unable to maintain even reasonable profitability. The most critical factors contributing to their problems have been interest rate deregulation and the unprecedented high and volatile interest rate levels over the past several years. These interest rates have created large asset/liability mismatches and exposed an unprepared thrift industry to extensive interest rate risk.

It should be noted, however, that based on performance, the mutuals can be divided into two distinct groups. One group made up of the largest institutions, which are primarily confined to the New York City area, has suffered the greatest problems. Even with the substantial declines in interest rates over the past several years, through year-end 1984 these institutions continued to generate losses. It was not until this past July that virtually all the New York City savings banks began to turn a profit. Our projections show that interest rates will have to remain low and stable for an extended period before most of these institutions have any chance of regaining reasonable profitability.

On the plus side, the balance of the mutual savings banks outside the New York area returned to profitable status in 1983 although their current levels of earnings remain well-below historical levels. Most of these institutions profited from less stringent usury laws and more liberal investment powers than their New York City counterparts. This group of mutuals was, therefore, not as vulnerable to the dramatic interest rate fluctuations. But even these institutions are depending on moderate interest rate levels to maintain profitability.

Liquidity

Now I will turn to a most interesting industry measure -- liquidity. There is no doubt that liquidity is one of the most important elements in determining the overall condition of individual banks and the banking system as a whole. The problem is, however, that there is no single benchmark currently used that can capture the many facets of liquidity. Indeed, market confidence, which may be correlated to asset quality, capital and earnings may be the most important factor.

As I have mentioned previously, we find ourselves in an era of financial innovation. In response to rapidly changing external events, banks are devising new products and operating procedures to deal with those challenges. We are seeing brokered deposits, asset "securitization," broadened secondary markets, forwards, futures, interest rate swaps and a variety of other financial commitments. To manage these new products, banks have developed such tools as liability management, gap management, duration analysis, modeling, simulation and a variety of hedging techniques. The result is that it is increasingly difficult to understand and evaluate liquidity, especially for larger institutions that are actively involved in the purchased funds market.

Using traditional measures -- that is measuring liquidity by the percentage of volatile liabilities to assets -- we have noticed that the volume of volatile funds tracks the economic and interest rate cycle fairly closely. The volume of purchased money rose through the late 1970s and peaked during the credit crunches of 1980 and 1981. Thereafter, the volumes decreased in 1982 and 1983; 1984 was up very slightly from 1983 but preliminary indications are that they have fallen back a bit in 1985. Also observable is the tendency for the amount of purchased funds to increase as bank size increases. For example, at the end of 1984 volatile liabilities for nonmember banks were 13.7 percent of assets in small banks, 22.3 percent in medium size banks and 33.9 percent in large banks.

Brokered Deposits

At this point, Mr. Chairman, I would be remiss if I did not mention the subject of brokered deposits. The use of deposit brokers to place fully insured investment monies has rapidly become one of the most serious problems facing the Federal deposit insurance system today. There are essentially two distinct problems associated with this issue -- one systemic and one supervisory.

First, current brokered funding practices have a very real potential to erode the deposit insurance system and call into question our ability to adhere to the purposes and original goals Congress established for the FDIC -- that is, promote stability in the banking system and provide protection to the Nation's small depositors. We do not think it proper to "leverage" upon the Federal guarantee of deposits for what are essentially high-yield seeking investment funds.

The second problem is that of risk control in troubled banks -- the primary area of concern for the Division of Bank Supervision. Insured institutions, by using brokered funding, can significantly expand or alter their very nature in as short a period of time as a few business days. Normal bank supervisory and risk control techniques can thus be rendered ineffective. All too often, we have found that the weakest banks are the worst abusers of this market and their failures have cost us hundreds of millions of dollars. Our potential liability runs into the billions. From our perspective, there is no problem more threatening to the deposit insurance fund.

Problem Banks

With regard to problem banks, I have already mentioned that more than 1,000 FDIC-insured commercial banks and thrift institutions have been accorded a "problem" designation. Without a doubt, this represents a dramatic increase in number from only a few years ago when, as recently as 1981, only 233 banks were so categorized. But, keep in mind that this means that more than 90 percent of the Nation's banks are not facing serious problems.

I also think it's important to emphasize that most problem banks do not fail and their managements are usually successful in overcoming the bank's particular difficulties long before there is any real danger of failure. As Chairman Isaac has stated on numerous occasions, there is a great deal of turnover on our problem bank list. We have provided you with statistics which demonstrate the number of banks going off the problem list as a result of improvements following regulatory orders.

There is a correlation between unfavorable economic environment and an increase in the number of problem banks. It would be simplistic, however, to dwell on this as the only direct cause-and-effect relationship. Deregulation of the banking industry and major advances in technological innovations have brought on dramatic change and served to increase risks. Many bankers are still learning and experimenting with ways of coping with the new challenges and competitive pressures.

A volatile economic environment and increased competitive pressures do not cause bank failure, _per se_. They are merely the catalysts, increasing the risks for banks and exacerbating existing weaknesses. Those banks which are poorly managed or marginally operated are the first to be adversely impacted when external circumstances turn unfavorable. That is why we are so concerned with the management factor. Good management can, and usually does, make the difference between a bank's success or failure.

SUPERVISORY AND REGULATORY RESPONSE

Mr. Chairman, you also inquired as to the supervisory response of the FDIC to the growing number of problem institutions. First, we have redirected our bank examination efforts, focusing less on the thousands of generally well-run banks while intensifying our effort on those institutions which present the greatest possibility for loss or failure. In doing so, we have developed a formal cooperative examination program with both the OCC and the FHLBB, and we are examining problem state member banks when necessary. Our improved offsite monitoring program is used to screen banks and to identify adverse trends or developing problems. Targeted "visitations" are also being used with increased frequency to monitor these institutions.

When problems have been identified and when these problems are not being successfully addressed by the bank's management we are vigorously pursuing enforcement actions tailored to the risks posed by the individual institution. These range from negotiating a simple agreement with bank management regarding a specific area of concern to the formal removal of bank officials and the imposition of fines or monetary penalties. Over the last five years there has been a substantial increase in our use of both formal and informal administrative enforcement actions. These actions include cease-and-desist orders, fines against officers and directors, removal actions and proceedings to terminate FDIC insurance. In each of the last two years, for example, there were about 250 enforcement actions, up from 50 in 1980. Total fines in 1980 came to only $2,000, while so far this year they total $8.8 million. This year there have been 25 bank officials removed by the FDIC, up from 23 in 1984, nine in 1983, six in 1982 and only one in 1981. At mid-1985 there were more than 400 formal actions outstanding under the FDIC's Section 8 authority and it is estimated that there are more than 1,000 negotiated Memoranda of Understanding with bank managements currently in force.

As regulators, however, we are constantly seeking new ways to improve our methods of supervision so that the system can remain strong. The complexity of today's environment has forced each agency to mount major efforts to improve examiner training and performance. In addition, millions of dollars are being spent on improved offsite monitoring techniques. We are targeting our supervisory efforts in those areas where our exposure is the greatest: mainly larger institutions and troubled banks. And, as I have already mentioned, we have taken steps to raise capital ratios and have increased the use of formal enforcement actions against banks, their officers and directors.

But there is much more that needs to be done. In today's deregulated environment, the inherent limitations of supervision and regulation must be recognized. That is why we are seeking the support of the marketplace in our efforts to create a stronger, more disciplined system. Public disclosure of the financial condition and practices of banks has been enhanced in recent years and these efforts will continue. The objective is to encourage depositors' funds to flow to the vast majority of banks that are well-managed rather than to the high-risk institutions that pay the highest rates. We are also researching various proposals that would enable suppliers of capital, possibly through the use of subordinated debt, to provide a measure of market discipline. This measure would address the off-balance sheet issue because banks which subject themselves to increasing off-balance sheet risk would be penalized in the marketplace by having to pay higher rates for funds.

Finally, we have put forth proposals for improving our deposit insurance system. Among the important reforms included in those proposals are risk-related insurance premiums and the authority to charge problem banks for costs of increased supervision. We are also seeking strengthened enforcement authority over all insured banks. While none of these reforms is a panacea, they are steps that need to be taken.

Thank you. I will be pleased to respond to any questions.

Chairman **St Germain**. Now we will hear from Michael Patriarca, Deputy Comptroller of the Currency, accompanied by Jonathan Fiechter and John Downey.

Mr. Patriarca, we will put your statement in the record, without objection, and you may proceed.

STATEMENT OF MICHAEL PATRIARCA, DEPUTY COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY, ACCOMPANIED BY JONATHAN FIECHTER AND JOHN DOWNEY

Mr. **Patriarca**. Thank you, Mr. Chairman.

I am pleased to relate the view of the Office of the Comptroller of the Currency [OCC] that the overall condition of the national banking system is sound. This assessment, however, is not unqualified; the number of problem institutions and bank failures has continued to increase and their numbers are troublesome.

In 1984, national bank performances as measured by earnings, asset quality and capital reflected the lingering effects of recession, intense competition, and to a lesser degree, adjustments to deregulation.

National bank return on assets and return on equity both fell for the fifth year in a row. There was a slight improvement in bank asset quality over the 1983 level, but asset quality continues to reflect the recessionary climate of the early eighties. Banks improved their capital positions and increased their reserves for loan losses in 1984 in response to these continuing asset problems as well as in response to initiatives from the OCC.

Economic downturns in specific sectors of the economy were the primary factors contributing to continued loan quality problems and the steady increase in the number of problem banks and bank failures of 1984.

Problems in energy and agricultural lending have been aired thoroughly both in previous testimony and in the press. Fundamentally, the problems arose when the inflationary bubble burst. There followed stagnation and decline in commodity prices and erosion of both debt servicing capacity for the borrower and collateral value for the banks. The result, of course, has been a disproportionate number of problem banks and bank failures among agricultural and energy lenders. There appear to be few prospects for early relief for either the agricultural or energy sector.

In addition, some of the largest U.S. banks lost significant income because of problems in the international economy. Depressed commodity prices, slow economic growth, high real interest rates and protected debt negotiations have caused continuing payment delays among international borrowers. As a result, U.S. multinational banks have had to place many of their international loans on a nonaccrual basis and increase their loan loss reserves for international loans.

A second and less demonstrable factor affecting the condition of the banking system is the structural change that is taking place in the financial services industry. Although the effects of these factors on bank performance to date are unclear, the underlying changes in the financial environment have permanently increased the complexity and riskiness of the banking business. Future bank performance will reflect that fact.

The sectoral problems just discussed and changes in the financial marketplace have increased the challenge for bank supervisors. As supervisors, we have attempted to minimize the impact of bank failures and the negative effects of troubled banks on the safety and soundness of the system. We have identified areas where the supervisory process can be adapted to address the economic and environmental pressures on the industry. For example, we have prepared a proposal to increase bank disclosure requirements. It would extend to all national banks disclosure requirements similar to those faced by publicly held banks and registered bank holding companies. This would make bank management more accountable to its shareholders, its depositors, and the public.

In addition, we are considering imposing risk based capital requirements. Earlier this year, under the authority of the International Lending Supervision Act of 1983, the three Federal banking agencies imposed a uniform minimum capital-to-asset requirement for all commercial banks. However, we view the capital requirement presently in place as only an interim step because it has two deficiencies. First, the present minimum capital requirement treats all assets equally regardless of risk or liquidity. Second, the present capital-to-asset requirement fails to take explicitly into consideration other risks assumed by a bank that do not appear on the balance sheet. Therefore, we are determining the feasibility of a capital requirement that would be based on the overall riskiness of a bank's activities, both on and off the balance sheet.

Further, the Comptroller's office is exploring a proposal that would give the regulatory agencies the authority to respond earlier and more forcefully to problem institutions. Earlier supervisory action would reduce the likelihood that a bank with negative capital could continue to operate. For example, any time a bank's capital falls below 3 percent, the level at which we routinely ask the FDIC to consider termination of deposit insurance, the primary supervisor could be given the authority to require the owners to seek a merger partner, or to liquidate the bank or to appoint a conservator to do so. Such mergers would serve to further protect the deposit insurance fund by addressing serious problems at a prefailure stage.

The increased risk and complexity posed by the financial marketplace require input from all participants, not just the regulators. Bank management must acknowledge that its environment has changed and adapt its policies and procedures accordingly, recognizing that it will be held more accountable for its actions than in the past. And, bank directors must be prepared to hold management accountable for poor performance.

Congress can facilitate bank adaptation to the underlying changes in the marketplace by proceeding with the relaxation of product and geographic restrictions. New product and geographic flexibility is also important to allow banks to reduce their vulnerability to economic fluctuations. Diversification of income sources and customer bases could greatly alleviate banks' susceptibility to economic volatility.

Congress can also assist the regulatory agencies in assuring systemic safety and soundness by implementation of the measures discussed earlier, in particular, providing the FDIC with the authority to terminate deposit insurance more quickly and the supervisory agencies with more flexibility in dealing with problem institutions.

In conclusion, the overall condition of the national banking system is sound. Although problem banks and bank failures are increasing, this is a phenomenon affecting primarily those banks with concentrations of loans to those sectors that are experiencing severe economic downturns. This increase does not reflect a widespread deterioration of the banking system.

Working together, the OCC, other regulators, banks, and Congress can assure a banking system that is sound in the future.

Thank you.

[The prepared statement of Mr. Patriarca, on behalf of the Office of the Comptroller of Currency [OCC], follows:]

Statement of

Michael Patriarca
Deputy Comptroller
Office of the Comptroller of the Currency

Before the

Subcommittee on Financial Institutions Supervision,
Regulation and Insurance

Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

September 11, 1985

Mr. Chairman and members of the Subcommittee, I am pleased to relate the view of the Office of the Comptroller of the Currency (OCC) that the overall condition of the national banking system is sound. While many national banks have been confronted with numerous challenges in recent years, the system as a whole is stable and earns the public's continuing confidence.

Unprecedented economic volatility in recent years has resulted in an increasing number of problem banks and bank failures. This increase does not reflect a widespread deterioration of the banking system. Rather, it reflects sharp declines in certain sectors of the economy that are, in turn, adversely affecting a small percentage of banks.

Over and above the economic pressures faced by a portion of the banking industry, bank performance reflects changes in the financial sector that are revolutionizing the environment in which banks operate. Those environmental changes have increased significantly the risk and complexity of the banking business. In response, the OCC is undertaking efforts to make bank management more accountable through increased bank disclosure and is contemplating imposing risk-based capital requirements to strengthen the capital structure of the banking system.

In what follows, I will first discuss the current financial performance of the national banking system as measured by earnings, asset quality, capital, loan loss reserves and liquidity. Then, I will review the economic factors that have influenced bank performance, and the environmental changes that are reshaping the financial services marketplace. Finally, the response of this Office to these factors and the needed actions of banks and the Congress will be discussed. The Appendix to this testimony presents detailed financial data regarding the condition of the national banking system.

CONDITION OF THE NATIONAL BANKING SYSTEM IN 1984

The national banking system remains sound despite the lingering effects of recession, intense competition and, to a lesser degree, adjustments to deregulation. Aggregate net income of national banks increased in 1984. The profitability of the national banking system, however, continued a downward trend. National bank return on assets (ROA) and return on equity (ROE) both fell for the fifth year in a row. Typically, at this stage of the business cycle, the banking system should be exhibiting stronger profits.

Behind these systemic trends, however, there was substantial variation in the performance of banks both across size classes and within size classes. In the current environment, many banks are earning reasonable profits. At the same time, profits are lower at banks with large exposures to troubled sectors of the economy, particularly at banks that also lack strong management. For example, although aggregate ROA for the national banking system was 0.55 percent in 1984, over 70 percent of national banks had ROAs in excess of 0.55 percent, and 40 percent had ROAs of over 1 percent.

Asset Size

There were approximately 4,800 national banks at year-end 1984, representing one-third of the total number of insured commercial banks and holding approximately 55 percent of total commercial bank assets.

When assessing the condition of the national banking system, it is important to note the diversity within the industry. As can be seen in the following table, small banks account for over 90 percent of the number of national banks, but hold only 18 percent of total assets. Mid-sized national banks comprise 5 percent of all national banks, with over 8 percent of the system's assets. Large national banks represent less than 4 percent of all national banks, but account for 74 percent of the national banking system's assets. Of those large banks, 164 are regional banks with assets between $1 billion and $10 billion, and 17 are multinational banks with assets over $10 billion.

Size Distribution of National Banks
as of Year-end 1984

Size Class	Number of Banks	% of Total National Banks	Assets ($ billions)	% of Total National Bank Assets
Small Banks				
Under $300 million	4,426	91.3%	$267	18.0%
Mid-sized Banks				
$300 million-$1 billion	243	5.0	124	8.4
Large Banks				
Over $1 billion	181	3.7	1,089	73.6
Total	4,850	100%	$1,480	100%

Earnings

The earnings and profitability of national banks are important determinants of their ability to manage economic volatility and to fund growth. A banking system requires strong, steady growth in earnings to build reserves needed to absorb losses that occur in the normal course of the business cycle. Furthermore, an attractive rate of profitability is necessary to assure investors of a reasonable dividend yield and prospective capital appreciation. Therefore, if the national banking system is to remain strong over time, the recent trends of only modest earnings growth and declining profitability must be reversed.

As can be seen in the following table, small bank ROA declined significantly in 1984. The decline in earnings at small banks is attributable to two factors. First, small bank net interest margins declined for the second year in a row reflecting the increased funding costs associated with high interest rates and greater reliance on market rate deposits. The second and more important factor reducing small bank profitability was the increase in the provision for loan losses. The average provision for loan losses in 1984 was three times greater than the level for the decade of the 1970s.

Return on Assets

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	0.77%	0.85%	0.46%	0.55%
1983	0.86	0.76	0.48	0.57
1982	0.91	0.75	0.54	0.63
1981	0.98	0.85	0.58	0.68
1980	1.02	0.86	0.59	0.70

In contrast to the decline in small bank ROA, a different earnings picture emerged among mid-sized and large national banks. On average, mid-sized national banks experienced a significant increase in profitability in 1984. Their net interest margins declined, but less than the degree experienced by small banks. Mid-sized banks' loan loss provisions were stable, and they had the greatest increase in fee income in 1984.

The ROA of large banks was almost unchanged at 0.46 percent in 1984. In contrast to smaller national banks, those banks in the large size category managed to maintain or even boost their net interest margins during 1984. This was partially offset, however, by increases in overhead expenses, which have become a fast-rising cost category.

Among the large banks, regional bank ($1 billion-$10 billion in assets) ROA rose significantly from 0.56 in 1983 to 0.72 in 1984. However, multinational bank (assets over $10 billion) ROA declined from 0.41 percent in 1983 to 0.23 percent in 1984. This decline is attributable to the problems that Continental Illinois experienced in 1984. If Continental Illinois is excluded from the 1984 calculation, ROA for the multinational banks remains virtually unchanged at 0.42 percent.

Changes in national banks' return on equity in 1984 paralleled changes in ROA. National bank ROE declined to 9.32 percent in 1984 from 10.12 percent in 1983. Since 1980, ROE at national banks has declined by almost 3.5 percentage points.

Return on Equity

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	9.69%	12.52%	8.71%	9.32%
1983	10.81	11.28	9.66	10.12
1982	11.43	11.09	11.50	11.44
1981	12.31	12.67	12.54	12.49
1980	12.88	12.75	12.75	12.79

The overall decline in ROE reflects declines at the small and large banks. Small bank ROE fell by over a full percentage point during 1984 to 9.69 percent. For the large banks, the decline in ROE was primarily due to the problems experienced by Continental Illinois in 1984. When Continental Illinois is excluded from the 1984 calculation, ROE at large banks declines by a more modest amount.

Asset Quality

Asset quality reflects the condition of the economy. The deterioration of bank asset quality throughout the decade reflects the recessionary climate of the early 1980s. In 1984, aggregate classified assets at national banks declined only slightly from their 1983 level.

Weighted Classified Assets* as a Percent of Total Assets

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	0.86%	0.69%	1.29%	1.15%
1983	0.77	0.78	1.31	1.16
1982	0.67	0.76	0.98	0.90
1981	0.50	0.50	0.63	0.60
1980	0.45	0.44	0.53	0.51

*Aggregate classified assets (20% of substandard + 50% of doubtful + 100% of loss) divided by aggregate total assets.

As noted earlier, problem loans at small banks continued to grow, as reflected in the rise in their classified assets to 0.86 percent of total assets. This was offset, however, by an improvement in classified assets at mid-sized and large banks.

Capital and Loan Loss Reserves

The adequacy of capital is an important factor in a bank's ability to withstand credit and operating losses. Regulatory initiatives and continuing asset problems led banks to bolster their capital positions in 1984. Primary capital, as a percentage of total assets, rose to 6.6 percent in 1984 from 6.3 percent in 1983 and 6.0 percent in 1980. Since 1980, primary capital at national banks has increased by about $32 billion.

Primary capital as a percentage of total assets at small banks averaged 8.6 percent in 1984, an amount well in excess of regulatory requirements. This has been a key factor in the ability of most small banks, even those with loan portfolios concentrated in industries such as agriculture, to weather loan losses. The capital-to-asset ratio at mid-sized banks was a healthy 7.5 percent, and recent injections of capital by several multinational banks boosted average capital ratios of the large banks to 6.1 percent from 5.7 percent in 1983.

Primary Capital of National Banks By Size, 1983-1984

Size Class	Primary Capital/ Total Assets (%) 1983	Primary Capital/ Total Assets (%) 1984	Reserves/Total Assets (%) 1983	Reserves/Total Assets (%) 1984
Small Banks				
Under $300 million	8.5%	8.6%	0.59%	0.67%
Mid-sized Banks				
$300 million-$1 billion	7.4	7.5	0.66	0.71
Large Banks				
Over $1 billion	5.7	6.1	0.72	0.80
Total	6.3%	6.6%	0.69%	0.77%

While we are encouraged that capital-to-asset ratios have been increasing for several years, whether a bank's capital level is adequate depends on its level of risk. For that reason, as will be discussed later in this testimony, we are studying the concept of risk-based capital requirements.

At this point, we only have a rough idea of what national bank capital levels are on a risk-adjusted basis. When capital is reduced to reflect classified assets and taken as a percentage of total assets plus standby letters of credit, the national banking system capital ratio is 5.1 percent. Adjusted in this way, capital is found to have declined from 1980 until 1983, and to have increased in 1984. These adjustments, however, are incomplete. For example, low risk assets such as government securities should demand far less capital than loans, and an accurate risk-adjusted capital measure should reflect that.

National banks have also increased reserves for loan losses, a component of primary capital, in response to OCC directives addressing asset quality deterioration in recent years. As of year-end 1984, national banks had over $11 billion, or 0.77 percent of assets, in reserves for loan losses.

Liquidity

Liquidity is a bank's most important safeguard against funding difficulties. Even the most well-managed banks are not invulnerable to a sudden erosion of market confidence. For that reason, the OCC monitors the diversity and stability of funding sources and the liquidity of assets, particularly at regional and multinational banks.

Somewhat divergent trends in bank liquidity have recently become apparent. Asset liquidity has declined, but at the same time, banks' dependence on volatile liabilities has also declined. Thus, although overall liquidity is down, the industry's need for liquidity is lessened somewhat by a greater stability of funding sources.

Asset liquidity, as measured by the proportion of assets invested in cash and securities relative to loans and leases, typically responds to the credit demands of the business cycle.

Due to the back-to-back recessions in 1980 and 1981-82, the ratio of loans and leases to total assets remained relatively stable at about 56 percent during the period 1980 to 1983.

As the recovery progressed, however, loan demand grew. In addition, higher capital-to-asset requirements for the very large banks may have encouraged them to increase their holdings of less liquid, higher yielding assets, such as commercial loans, in order to maintain their ROEs. As a result, in 1984, the proportion of bank assets allocated to loans rose by almost one-tenth to 61.5 percent. Most of the loan growth occurred at mid-sized and large banks.

Dependence on volatile liabilities has lessened over the past several years. Increased bank competitiveness for retail deposits and lessons derived from the experience of Continental Illinois have combined to cause many bank managers to restructure their funding sources to attract and retain a higher proportion of more stable deposits.

Dependence on purchased funds peaked in 1981 at 45 percent of assets for all national banks and has since declined to 36.8 percent. While this decline has occurred at banks of all sizes, it has been most pronounced among the largest national banks, which reduced money market dependence from 54.9 percent to 44 percent of assets.

The effect of brokered deposits on national bank liquidity remains quite small. As of March 31, 1985, only 270 national banks, or 6 percent of all national banks, reported any brokered deposits. At most of these banks, brokered deposits comprised less than 10 percent of total deposits. The use of brokered deposits, however, does raise supervisory concerns, particularly among troubled banks, and the OCC is continuing to exercise a wide range of restrictions and limitations on brokered deposits on a case-by-case basis.

SECTORAL FACTORS AFFECTING NATIONAL BANK PERFORMANCE

The effects of the strong dollar on export-dependent sectors and the dampening of inflationary expectations have contributed to major weaknesses in specific sectors of the economy. These sectoral problems have resulted in continued asset quality deterioration, and a steady increase in the number of problem banks and bank failures. As of last month, 261 national banks were problem banks, defined as those banks rated "4" or "5" under the Uniform Financial Institutions Rating System.

Bank failures have also been increasing. During the 1970-1981 period, commercial bank failures averaged nine per year. However, as shown below, the number of bank failures has increased dramatically since 1982. The sectors of the economy most responsible for the increase in problem banks and bank failures are the agriculture, energy, and real estate sectors. In addition, the downturn in the international economy has caused problems for banks.

Number of Failed Insured Banks

	Total Bank Failures	State Bank Failures	National Bank Failures
1985*	76	56	20
1984	79	62	17
1983	48	39	9
1982	42	32	10

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*As of August 31, 1985.

In the agricultural sector, an inflationary boom in farmland prices ended in the early 1980s. Commodity prices stagnated, land values began to fall, and the strong U.S. dollar and increased competition from foreign producers weakened demand for farm exports. As collateral values declined and debt servicing capacity was eroded, the quality of agricultural credits deteriorated. There appear to be few prospects for early relief for the agricultural sector. High productivity and bumper crops will keep commodity prices well below the levels reached five years ago.

The severe problems of the agricultural sector are reflected in the condition of agricultural banks, defined as those banks with 25 percent or more of their assets in agricultural loans. At year-end 1984, agricultural banks comprised 18 percent of the total number of national banks, but accounted for 31 percent of the 4 and 5 rated banks in the group. So far this year, over half of the total commercial bank failures have been agricultural banks.

The energy sector's problems are similar to those of agriculture -- an end to an inflationary bubble followed by excess capacity, weak demand, and falling prices. When expected increases in oil prices failed to materialize in 1982, many oil and gas producers began experiencing cash flow problems. Excess production drove oil prices down which, in turn, led to falling values for oil and gas fields and production equipment. As in the case of agriculture, there are no immediate prospects for a recovery in oil and gas prices. Increased oil production by overseas producers combined with modest economic growth by the industrialized countries may lead to stagnant, if not weakening, energy prices.

As of the first quarter of 1985, there were 224 national energy banks, defined as national banks with at least 25 percent of total capital in energy loans. Of those banks, 19 percent were 4 or 5 rated banks.

Nearly one-third of all bank lending is to the real estate sector, an area that has recently begun showing signs of economic problems. The significant reduction in the rate of inflation combined with overbuilding has resulted in declining real estate values and high vacancy rates in some parts of the United States. As a result, the quality of bank real estate loans is deteriorating. Therefore, we are analyzing real estate construction loan data gathered by metropolitan statistical area and will soon be better able to quantify the implications of the real estate sector's problems for national banks.

In addition, some of the largest U.S. banks lost significant income because of problems in the international economy. Depressed commodity prices, slow economic growth, high real rates of interest, and protracted debt negotiations have caused continuing payment delays among international borrowers. As a result, U.S. multinational banks have had to place many of their international loans on a non-accrual basis and increase their loan loss reserves for international loans.

Although some 200 U.S. banks lend internationally, nearly 60 percent of U.S. banks' international loans are concentrated in the nine largest commercial banks. At year-end 1984, those banks reported total foreign nonperforming loans at $8.1 billion. Those foreign nonperforming loans were equal to 1.8 percent of their total loans and 55 percent of total nonperforming loans.

ENVIRONMENTAL FACTORS AFFECTING NATIONAL BANK PERFORMANCE

A second and less demonstrable factor affecting the condition of the banking system is the structural change that is taking place in the financial services industry. There have been many forces behind that change. For example, improved technology has made it possible to provide financial services more quickly and less expensively than before. Nonbank financial service providers are less restricted than banks and are utilizing new technologies to compete for market share. Consumers of financial services are becoming more discriminating and are increasingly demanding high-quality, innovative products. Furthermore, the financial market is no longer local; it has become national, and even global, in scope.

Although the effects of these factors on bank performance to date are unclear, the underlying changes in the financial environment have permanently increased the complexity and riskiness of the banking business. Future bank performance will reflect that fact.

REGULATORY RESPONSE

Economic volatility in recent years has been more severe than in past decades, bringing with it increased bank failure rates. The government, however, neither can nor should completely insulate banks from sectoral economic downturns or the dynamics of the financial marketplace. Our bank regulatory system is not designed to prevent bank failures. To do so would require either nationalization of the banking industry, or the elimination of all risk -- one consequence of which would be to preclude banks from funding the nation's economic growth.

Supervisors do, however, have a role in minimizing the impact of bank failures and the negative effects of troubled banks on the safety and soundness of the banking system. The demanding economic climate of the 1980s and the emerging risks due to the rapidly changing financial services marketplace have indicated that supervisors need increased authority to deal with problems quickly and effectively enough to minimize the risk to the system. We have identified two areas where the supervisory process can be adapted to address the economic and environmental pressures on the industry. The first is to make bank management more accountable through increased disclosure. The second is to establish risk-based capital requirements.

Increased Bank Disclosure

Public disclosure complements the OCC's supervisory efforts by enabling the marketplace to participate in controlling risk-taking by banks. The OCC is currently considering a proposal to increase bank disclosure requirements. It would extend to all banks disclosure requirements similar to those faced by publicly held banks and registered bank holding companies. The disclosure required of the larger banks has imposed elements of market discipline on them, and we expect our proposal will do the same for smaller banks. Increased disclosure would make bank management more accountable to its shareholders, its depositors, its supervisors, and the public. It would also enable depositors and investors to better gauge the performance of all individual banks and thus make informed decisions on where to place funds.

Risk-Based Capital Requirements

We also believe that the capital structure of the banking system should be strengthened. Earlier this year, under the authority of the International Lending Supervision Act of 1983, the three federal banking agencies imposed a uniform minimum capital-to-asset requirement for all commercial banks.

However, we view that recent capital regulation, which employs a simple capital-to-asset ratio, as only an interim step because it has two deficiencies. First, the present minimum capital requirement treats all assets equally, regardless of risk or liquidity. Therefore, to the extent that the regulation forces banks to raise their capital-to-asset ratio, banks are likely to increase the yield on their assets in order to maintain their ROE. The result may be an increase in the overall riskiness of a bank's assets as low-yielding, low-risk assets such as Treasury securities and loans to high-quality borrowers are replaced with higher yielding, riskier assets.

The second deficiency in the present capital-to-asset requirement is that it fails to take explicitly into consideration other risks assumed by a bank that do not appear on the balance sheet. It therefore encourages banks to shift activities off of their balance sheets. The result is that traditional measures for gauging the relative strength of individual capital positions may be misleading, if not invalid. As shown in the table below, the use of standby letters of credit has grown dramatically at large banks. These standbys, although generally issued to very strong borrowers, represent an assumption of credit risk by the issuing bank even though no loan has been made.

Standby Letters of Credit as a Percentage of Total Assets

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	$1 billion-$10 billion	Over $10 billion	Total
1984	0.7%	1.5%	3.9%	11.3%	6.1%
1983	0.7	1.6	3.2	9.6	5.3
1982	0.6	1.5	3.0	8.3	4.8
1981	0.5	1.6	2.2	6.8	3.9
1980	0.4	1.1	1.7	5.0	2.8

Other major off-balance sheet activities include the issuance of loan commitments, foreign exchange commitments, and interest rate swaps. In fact, there are literally dozens of activities including electronic data processing, trust department activities and mortgage banking activities that create credit, interest rate, funding, fiduciary, or operating risks for a bank. Some of these activities have been conducted by banks for years; others have arisen more recently as banks seek to retain customers who can now go directly to the capital markets for some of their basic borrowing needs.

Because of our concerns with present capital-to-asset ratios, we are studying the feasibility of a risk-based capital requirement. Under such an approach, the minimum capital requirement would be based on the overall riskiness of a bank's activities, both on and off the balance sheet. Factors to be taken into consideration include credit risks, asset concentrations, off-balance sheet activities, interest rate risk, and liquidity.

We believe that the changing nature of risk in the financial system may require moving to risk-based capital requirements for depository institutions. We believe that simply increasing the capital-to-asset ratio further is likely to be ineffective in strengthening the banking system and may even weaken it.

Other Actions

Numerous other proposals have been put forth that are designed to address the economic pressures and emerging risks facing the industry. One of the most common is risk-based deposit insurance premiums. It is argued that if banks are required to pay insurance premiums commensurate with their level of risk, they would be more prudent and the insurance fund would be exposed to less risk.

While we have long been supporters of requiring banks to bear the burdens -- as well as the gains -- of the risks they take, we feel that the risk-based capital approach is preferable to relying on risk-based insurance premiums. Requiring the level of capital to be commensurate with a bank's risk would be a more direct way to encourage reasoned risk-taking, and would involve more of the marketplace -- equity holders -- in the process of disciplining banks.

We do feel, however, that providing the FDIC authority to terminate insurance more quickly, as the FDIC has proposed, would have a salutary effect on the safety and soundness of the industry and the risk to the insurance fund. Bank management would be discouraged from making imprudent decisions if it knew that the bank could lose its insured status as a result of those decisions. This would be especially beneficial as the business of banking, and the decisions of management, become more fast-paced and complex.

Along a related vein, the FDIC has proposed that it have greater enforcement authority over national banks and state banks belonging to the Federal Reserve System that are experiencing difficulties. We view this as unnecessary and not in keeping with the FDIC's role. As the insuring agency, the FDIC has full authority to grant, deny, or terminate insurance coverage. As the supervisor of national banks, it is the responsibility of the OCC to conduct examinations and, when necessary, to institut corrective actions. Over the past four years, the OCC has exercised 1,359 enforcement actions. We are not aware of any disagreement between the OCC and FDIC over our use of enforcement actions that would require greater FDIC enforcement authority.

Finally, this Office is exploring a proposal that would give the regulatory agencies the authority to respond earlier and more forcefully to problem institutions. Earlier supervisory action would reduce the likelihood that a bank with negative capital could continue to operate, thereby reducing the exposure of the FDIC, other creditors, depositors, and the public. For example, any time a bank's capital falls below 3 percent (the level at which we routinely ask the FDIC to consider termination of deposit insurance), the primary supervisor could be given the authority to require the owners to seek a merger partner or to liquidate the bank. Alternatively, a conservator, with authority to exercise the full range of powers possessed by bank management, including the sale of the bank, could be appointed by the primary supervisor. We would be pleased to work with the Subcommittee in exploring this idea further.

BANK AND CONGRESSIONAL RESPONSES

The increased risk and complexity posed by the financial marketplace requires input from all participants, not just the regulators. Bank management must acknowledge that its environment has changed and adapt its policies and procedures accordingly, recognizing that it will be held more accountable for its actions than in the past. In addition, bank directors, like supervisors, must be prepared to hold management accountable for its performance.

Congress can facilitate bank adaptation to the underlying changes in the marketplace by proceeding with the relaxation of product and geographic restrictions. If banks are to keep pace with less regulated competitors in meeting market demands, they need more flexibility to adjust to changes in their environment. While other financial services providers have diversified, expanded, and innovated to keep pace with new technologies and market demands, banks have largely had to sit on the sidelines. Providing banks or bank holding companies with new product and geographic flexibility would enable them to be viable competitors in the marketplace of today and tomorrow.

New product and geographic flexibility is also important to allow banks to reduce their vulnerability to economic fluctuations. Diversification of income sources and customer bases could greatly alleviate banks' susceptibility to economic volatility.

Congress can also assist the regulatory agencies in assuring systemic safety and soundness by implementation of the measures discussed earlier. In particular, providing the FDIC with the authority to terminate deposit insurance more quickly and the supervisory agencies with more flexibility in dealing with problem institutions would enhance the effectiveness of the regulatory agencies. As a starting point for much needed reform, the OCC encourages Congress to consider the recommendations of the Bush Task Force.

CONCLUSION

In conclusion, the overall condition of the national banking system is sound. Although problem banks and bank failures are increasing, this is a phenomenon affecting primarily those banks with concentrations of loans to those sectors that are experiencing severe economic downturns. In addition, an increasingly important factor that will affect the viability of banks into the future is the significant structural change that is taking place in the financial service sector.

The OCC neither can nor should insulate banks from sectoral economic downturns or the dynamics of the financial marketplace experienced by the banking system. The OCC, however, will continue to minimize the impact of troubled banks and bank failures on the safety and soundness of the banking system through its supervisory authority.

Congress can facilitate bank adaptation to the underlying changes in the marketplace through a relaxation of bank product and geographic restrictions and can ensure the continued effectiveness of national bank oversight by increasing the OCC's supervisory flexibility.

Working together, the OCC, other regulators, banks, and Congress can assure a sound banking system into the future.

* * *

I would be happy to answer any questions you or other members of the Subcommittee may have.

APPENDIX

Detailed Financial Data Regarding the Condition of the National Banking System

RETURN ON ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	0.77%	0.85%	0.46%	0.55%
1983	0.86	0.76	0.48	0.57
1982	0.91	0.75	0.54	0.63
1981	0.98	0.85	0.58	0.68
1980	1.02	0.86	0.59	0.70
1979	1.00	0.84	0.63	0.73
1978	0.94	0.78	0.60	0.69
1977	0.87	0.71	0.55	0.64
1976	0.85	0.68	0.57	0.65
1975	0.79	0.68	0.59	0.65

Definition: Aggregate net income divided by aggregate year-end total assets.

Source: Call Reports.

RETURN ON EQUITY

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	9.69%	12.52%	8.71%	9.32%
1983	10.81	11.28	9.66	10.12
1982	11.43	11.09	11.50	11.44
1981	12.31	12.67	12.54	12.49
1980	12.88	12.75	12.75	12.79
1979	13.01	12.91	13.57	13.33
1978	12.38	12.17	12.66	12.52
1977	11.82	10.90	11.32	11.42
1976	11.19	10.44	11.22	11.10
1975	10.90	10.57	12.39	11.62

Definition: Aggregate net income divided by aggregate year-end total equity.

Source: Call Reports.

WEIGHTED CLASSIFIED ASSETS (AS OF EXAMINATION DATE) AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	0.86%	0.69%	1.29%	1.15%
1983	0.77	0.78	1.31	1.16
1982	0.67	0.76	0.98	0.90
1981	0.50	0.50	0.63	0.60
1980	0.45	0.44	0.53	0.51
1979	0.38	0.39	0.60	0.53
1978	0.40	0.51	0.77	0.66
1977	0.44	0.65	0.95	0.80
1976	0.50	0.81	1.50	1.13
1975	0.47	0.84	1.49	1.14

Note: The data used to calculate these ratios were obtained from the most recently available examination report for each bank as of year end rather than call reports. Because of the intermittent nature of exam scheduling among banks, these data do not cover uniform periods. Therefore the data may differ from statistics obtained from year-end call reports.

Definition: Aggregate classified assets (20% of substandard + 50% of doubtful + 100% of loss), divided by aggregate total assets.

Source: 1979-1984, OCC.
1975-1978, FRB.

PRIMARY CAPITAL AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	8.59%	7.46%	6.05%	6.62%
1983	8.50	7.40	5.66	6.34
1982	8.53	7.36	5.37	6.13
1981	8.50	7.32	5.22	6.03
1980	8.44	7.33	5.18	6.02
1979	8.27	7.12	5.18	6.00
1978	8.09	7.00	5.23	6.05
1977	7.91	7.07	5.34	6.15
1976	8.08	7.14	5.56	6.39
1975	8.06	7.29	5.55	6.42

Definition: Aggregate year-end primary capital (total equity capital + allowance for loan and lease losses) divided by aggregate year-end total assets.

Source: Call Reports.

PRIMARY CAPITAL (AS OF EXAMINATION DATE) AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	8.66%	7.42%	5.73%	6.45%
1983	8.60	7.42	5.65	6.37
1982	8.66	7.45	5.32	6.15
1981	8.65	7.55	5.20	6.10
1980	8.55	7.47	5.12	6.03
1979	8.38	7.34	5.21	6.07
1978	7.76	6.92	4.97	5.83
1977	7.66	6.94	4.97	5.82
1976	7.54	6.77	4.77	5.81
1975	7.56	6.69	4.77	5.76

Note: The data used to calculate these ratios were obtained from the most recently available examination report for each bank as of year end rather than call reports. Because of the intermittent nature of exam scheduling among banks, these data do not cover uniform periods. Therefore the data may differ from statistics obtained from year-end call reports.

Definition: Aggregate primary capital at examination date (gross capital funds - subordinated debt 1979-1984, total equity + reserves on loans 1975-1978) divided by aggregate total assets.

Source: 1979-1984, OCC.
1975-1978, FRB.

PRIMARY CAPITAL (AS OF EXAMINATION DATE) LESS WEIGHTED CLASSIFIED ASSETS, AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	7.80%	6.73%	4.44%	5.29%
1983	7.84	6.65	4.34	5.21
1982	7.99	6.69	4.34	5.25
1981	8.15	7.04	4.57	5.95
1980	8.10	7.03	4.58	5.50
1979	8.00	6.95	4.61	5.54
1978	7.36	6.41	4.20	5.17
1977	7.22	6.29	4.02	5.02
1976	7.04	5.96	3.27	4.68
1975	7.08	5.85	3.28	4.62

Note: The data used to calculate these ratios were obtained from the most recently available examination report for each bank as of year end rather than call reports. Because of the intermittent nature of exam scheduling among banks, these data do not cover uniform periods. Therefore the data may differ from statistics obtained from year-end call reports.

Definition: Aggregate primary capital at examination date (gross capital funds - subordinated debt 1979-1984, total equity + reserves on loans 1975-1978) minus aggregate classified assets (20% of substandard + 50% of doubtful + 100% of loss) divided by aggregate total assets.

Source: 1979-1984, OCC.
1975-1978, FRB.

PRIMARY CAPITAL (AS OF EXAMINATION DATA) LESS CLASSIFIED ASSETS, AS A PERCENT OF THE SUM OF TOTAL ASSETS AND STANDBY LETTERS OF CREDIT

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	7.75%	6.64%	4.17%	5.05%
1983	7.79	6.55	4.08	4.98
1982	7.95	6.59	4.11	5.04
1981	8.12	6.96	4.37	5.31
1980	8.08	6.96	4.43	5.36
1979	7.98	6.90	4.48	5.43
1978	7.36	6.40	4.20	5.17
1977	7.21	6.27	4.01	5.01
1976	7.02	5.91	3.17	4.59
1975	7.07	5.80	3.15	4.50

Note: The data used to calculate these ratios were obtained from the most recently available examination report for each bank as of year end rather than call reports. Because of the intermittent nature of exam scheduling among banks, these data do not cover uniform periods. Therefore the data may differ from statistics obtained from year-end call reports.

Definition: Aggregate primary capital at examination date (gross capital funds - subordinated debt 1979-1984, total equity + reserves on loans 1975-1978) minus aggregate classified assets (20% of substandard + 50% of doubtful + 100% of loss), divided by aggregate total assets plus standby letters of credit.

Source: 1979-1984, OCC.
1975-1978, FRB.

TOTAL LOANS AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	54.31%	57.47%	63.70%	61.48%
1983	50.74	51.06	58.48	56.40
1982	50.20	49.38	58.34	56.08
1981	50.69	50.34	57.52	55.60
1980	51.87	50.51	56.15	54.80
1979	54.79	52.81	55.89	55.38
1978	55.08	52.81	55.75	55.46
1977	52.75	51.83	52.47	52.71
1976	50.31	50.89	51.04	50.34

Note: Data not available before 1976.

Definition: Aggregate year-end total loans and leases divided by aggregate year-end total assets.

Source: Call Reports.

VOLATILE LIABILITIES AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	14.58%	21.55%	44.02%	36.82%
1983	13.56	21.28	47.45	38.99
1982	15.00	26.18	52.51	43.35
1981	15.35	27.11	54.88	45.01
1980	14.30	25.00	54.05	43.68
1979	13.69	24.72	53.54	42.57
1978	13.08	24.78	52.67	41.09
1977	11.24	22.33	50.42	37.93
1976	10.88	21.01	45.70	32.83

Note: Data not available before 1976.

Definitions: Aggregate year-end volatile liabilities divided by aggregate year-end total assets.

Volatile Liabilities = Time Deposits in Denominations of $100,000 or More + Federal Funds Purchased and Securities Sold Under Agreements to Repurchase + Interest Bearing Demand Notes Issued to the U.S. Treasury and Other Liabilities for Borrowed Money (1978-1984), Other Liabilities for Borrowed Money (1976-1977) + Total Foreign Deposits.

Source: Call Reports.

Chairman St Germain. Thank you, Mr. Patriarca.

Now we will hear from Eric Hemel, Director, Office of Policy and Economic Research, Federal Home Loan Bank Board, accompanied by Frank Passarelli.

STATEMENT OF ERIC I. HEMEL, DIRECTOR, OFFICE OF POLICY AND ECONOMIC RESEARCH, ON BEHALF OF THE FEDERAL HOME LOAN BANK BOARD, ACCOMPANIED BY FRANK PASSARELLI

Mr. Hemel. I am pleased to represent the Federal Home Loan Bank Board before you in your hearings evaluating the need for modifications in the present system of Federal deposit insurance. No reform of insurance would be complete without a comprehensive discussion of the current problems facing the savings institutions industry. Due to problems with private deposit insurance funds in two States, the thrift industry and problems with deposit insurance have become interwoven in the public's perception. And undoubtedly, a large share of savings institution failures in recent years are at least partially attributable to the economic incentives for risk taking posed by our current deposit insurance system.

While I am going to concentrate on savings institutions in my remarks, I sincerely appreciate your taking this opportunity to focus on deposit insurance issues raised both by savings institutions and commercial banks. The issues posed for our current structure of Federal deposit insurance by savings institutions and commercial banks look substantially more similar than different. Savings institutions and commercial banks fulfill fundamentally different purposes—purposes which we at the Bank Board believe should remain distinctive and different. But the public policy issues posed by deposit insurance of these two sectors of our financial system are substantially identical.

It is ironic that the savings institutions industry has become the focus of so much public concern over the last several months. At least from a strict financial point of view, circumstances now appear better than at any other time in the last 5 years for the savings institutions industry as a whole. Interest rates are down dramatically, generally 300 to 350 basis points below what they were 12 months ago. The spread between average return on assets and the average cost of liabilities is probably in the process of reaching an alltime high in the third quarter of 1985.

On the basis of the second quarter's performance, it has become increasingly evident that earnings in the thrift industry will reach impressive heights this year and could set significant records if interest rates remain at moderate levels. This profitability will bolster the industry's capital position, and justifies optimism on the part of thousands of savings institutions officers and employees who are managing to survive and prosper in an environment of extraordinary challenges.

There are a number of other reasons for considerable optimism in regard to the future of the savings institutions industry as a whole. Throughout 1985, growth in the savings institutions industry has proven measured and restrained as more and more savings institutions have adopted sound and prudent growth strategies, while at the same time, continuing to restructure their asset/liability portfolios to reduce interest rate risk.

That is the good news. The bad news is simply that we had a rather substantial economic legacy leading into 1985, apart from just a large portfolio of below water, fixed-rate mortgages. It is important to focus exactly on what the legacy entails.

The savings institutions industry grew at an enormous rate throughout the last several years, 1983 and 1984 especially. In 1984, the industry was growing at over 20 percent a year. It was growing at a rate where it would double in size in just 3½ years. By contrast, commercial bank deposits were growing at less than 10 percent a year.

More significant as an indicator of the future than total thrift industry growth was the growth rate of a certain segment of the industry. Throughout 1984, institutions holding about one-seventh of the industry's assets were growing at a rate where they would double in size in 2 years or less. Forty percent of the industry's assets were in institutions growing at a rate where they would double in size in 4 years or less. Annual growth rates of several hundred percentage points were no longer uncommon, and in some parts of the country, appeared to have become the rule rather than the exception.

The dramatic significance of rapid growth became even more apparent when we examined the difference in asset composition between institutions growing rapidly and the savings institutions industry as a whole. Construction lending, which historically had far greater credit risks associated with it than other mortgage lending, was accounting for less than 6 percent of the assets of savings institutions generally, but almost 25 percent of the institutions doubling in 1 year or less. Acquisition and development loans—the lending category with the highest amount of associated credit risk—accounted for approximately 2 percent of savings institutions assets on average but almost 13 percent for rapid growers.

Direct investment in equity securities, real estate and service corporations accounted for only about 2 percent of total savings institutions assets, but over 10 percent for rapidly growing State-chartered institutions in California and Texas, the States with the most liberal asset authorities. Throughout 1984, direct investments by the savings institutions industry increased at close to a 100-percent annual rate. To put that number in perspective, at that rate of increase, the level of direct investments would have almost quadrupled in 2 years and increased 16-fold in 4 years.

We also saw a disturbing shift in the underlying reasons for savings institutions failing and falling into the FSLIC's clutches. Three years ago, approximately 80 percent of the FSLIC's caseload was primarily attributable to interest rate spread problems and only 20 percent was primarily attributable to asset quality problems. By 1984, that ratio had more than completely reversed itself, with almost all of the FSLIC's serious problems arising from the disposition of failed thrifts with failed assets. At today's interest rate levels, we simply do not expect to see any significant number of failures that are due primarily to assets paying below market interest rates. Peter Stearns, the Director of the FSLIC, will discuss these matters at greater length before this subcommittee tomorrow.

Given the various trends I have outlined, at the end of 1984, the Board understood that fundamental changes were necessary. If we had let things slide without fundamental regulatory actions, we would have seen hundreds of major failures over the next several years. The need to avoid unnecessary financial losses to the FSLIC resulted in two fundamental regulations that the Board passed last January 31.

Thank you.

[The prepared statement of Mr. Hemel, on behalf of the Federal Home Loan Bank Board, with an attached letter from Chairman St Germain containing questions regarding financial statistics of the thrift industry and FSLIC's problem caseload with attached responses follows:]

STATEMENT OF ERIC I. HEMEL, DIRECTOR, OFFICE OF POLICY AND ECONOMIC RESEARCH, FEDERAL HOME LOAN BANK BOARD

Mr. Chairman and Members of the Committee:

I am pleased to represent the Federal Home Loan Bank Board before you in your hearings evaluating the need for modifications in the present system of federal deposit insurance. No reform of deposit insurance would be complete without a comprehensive discussion of the current problems facing the savings institutions industry. Due to problems with private deposit insurance funds in two states, the thrift industry and problems with deposit insurance have become interwoven in the public's perception. And, undoubtedly, a large share of savings institution failures in recent years are at least partially attributable to the economic incentives for risk-taking posed by our current deposit insurance system.

While I am going to concentrate on savings institutions in my remarks, I sincerely appreciate your taking this opportunity to focus on deposit insurance issues raised both by savings institutions and commercial banks. The issues posed for our current structure of federal deposit insurance by savings institutions and commercial banks look substantially more similar than different. Savings institutions and commercial banks fulfill fundamentally different purposes -- purposes which we at the Bank Board believe should remain distinctive and different. But the public policy issues posed by deposit insurance of these two sectors of our financial system are substantially identical.

It is ironic that the savings institutions industry has become the focus of so much public concern over the last several months. At least from a strict financial point of view, circumstances now appear better than at any other time in the last five years for the savings institutions industry as a whole. Interest rates are down dramatically, generally 300 to 350 basis points below what they were 12 months ago. The spread between the average return on assets and the average cost of liabilties is probably in the process of reaching an all time high in the third quarter of 1985.

Preliminary data for the second quarter of the year show net income at FSLIC-insured institutions aggregated to approximately $1.2 billion for the period. This represents an annualized return on assets of 0.50 percent for the second quarter of 1985. Earnings for the period were two and one-half times greater than the first quarter of 1985, and represent the most profitable quarterly results since 1979.

On the basis of the second quarter's performance, it has become increasingly evident that earnings in the thrift industry will reach impressive heights this year and could set significant records if interest rates remain at moderate levels. This profitability will bolster the industry's capital position, and justifies optimism on the part of thousands of savings institution officers and employees who are managing to survive and prosper in an environment of extraordinary challenges.

Apart from the effect of moderate interest rates on quarterly earnings, a related but nevertheless noteworthy dividend of low rates is that the legacy of underwater fixed-rate mortgages, and the stranglehold they have imposed on the savings institutions industry, has become significantly attenuated. While calculations of this sort are only approximate, it is our estimate that the embedded economic losses represented by savings institutions holdings of fixed-rate mortgages are probably only about one-third today of what they were a year ago. Although the remaining losses are by no means negligible, the burden imposed by underwater fixed-rate mortgages is dramatically lower today than it has been at any time since the fall of 1979.

There are a number of other reasons for considerable optimism in regard to the future of the savings institutions industry as a whole. Throughout 1985, growth in the savings institutions industry has proven measured and restrained as more and more savings institutions have adopted sound and prudent growth strategies, while at the same time, continuing to restructure their asset/liability portfolios to reduce interest rate risk.

The market share of adjustable rate mortgages (ARMs) is continuing to climb. The ARM share of conventional home mortgages on single-family residences made by FSLIC-insured institutions rose to 61 percent in early July, up from 59 percent in early June and from 52 percent three months earlier. The continuing dominant role played by ARMs -- especially in light of recent declines in mortgage rates -- belies the notion that lower mortage rates make fixed-rate mortgages preferable to ARMs in the eyes of most homebuyers.

Another important development is that asset growth for FSLIC-insured thrift institutions as a whole occurred at an annual rate of only 6.3 percent in the first six months of 1985. This is less than one-third the growth rate of the industry in the corresponding period in 1984. For the entire first half of 1985, jumbo certificates of deposit (savings certificates in excess of $100,000) accounted for only two percent of total deposit growth of FSLIC-insured institutions. This is sharply less than the 26 percent jumbo certificate share in the preceding half year, and the 38 percent share in the first half of 1984. It is almost certain that the slowdown in savings institution growth, coupled with a shift away from jumbo certificates of deposit as a major source of growth, helped to bring about the declining cost of funds in the thrift industry in recent months. And yet, despite dramatically slower asset and liability growth, savings institutions closed $80 billion in mortgage loans in the first half of this year -- only six percent less than in the comparable period last year.

Recent profitability, coupled with moderate but not excessive growth in the industry, and the sigsnificant emphasis on adjustable rate mortgage originations by thrifts, all provide persuasive evidence that the savings institutions industry can adapt to a rapidly changing environment. Despite the very real difficulties a segment of the thrift industry is experiencing, and the critical need to reform, strengthen, and alleviate strains in our deposit insurance system, the long-term picture for a great majority of thrifts looks brighter today than at any other time in recent years.

That is the good news. The bad news is simply that we had a rather substantial economic legacy leading into 1985, apart from just a large portfolio of below-water, fixed-rate mortgages. It is important to focus exactly on what the legacy entails.

The savings institutions industry grew at an enormous rate throughout the last several years, 1983 and 1984 especially. In 1984, the industry was growing at over 20 percent a year. It was growing at a rate where it would double in size in just three and one-half years. By contrast, commercial banks deposits were growing at less than 10 percent a year.

More significant as an indicator of the future than total thrift industry growth was the growth rate of a certain segment of the industry. Throughout 1984, institutions holding about one-seventh of the industry's assets were growing at a rate where they would double in size in two years or less. Forty percent of the industry's assets were in institutions growing at a rate where they would double in size in four years or less. Annual growth rates of several hundred percentage points were no longer uncommon, and in some parts of the country, appeared to have become the rule rather than the exception.

At the end of last year, in order to put these growth trends into tangible perspective, the Board's Office of Policy and Economic Research extrapolated just how soon certain savings institutions in the country would achieve the size of the largest savings institution in the country -- approximately $30 billion in assets -- if their 1984 growth trends had continued. The results of this rather simple exercise in extrapolation were illustrative. Not including institutions under $100 million in size -- if growth rates prevailing in 1984 had continued -- within four years, 19 savings institutions would have reached the $30 billion threshold; within seven years, 86 institutions would have reached that threshold; and within 10 years, 230 institutions would have reached the $30 billion mark. These numbers were not taken seriously as precise estimates. Long before these results could occur, our regulatory system would have almost certain fallen under its own weight. But these numbers did demonstrate quite graphically that if current trends continued, there would soon be hundreds of multibillion dollar institutions whose growth had occurred almost entirely in the previous years.

Rapid growth is not always alarming -- at least not when it is accompanied by high real earnings and sound operating strategies. What made this situation unique, by the end of 1984, was that rapid growth could result entirely from the aggressive solicitation and deployment of funds without any strong correspondence to sound and sustained earnings or to managerial expertise. Of the hundreds of savings institutions that were doubling in size every year, it appeared almost certain that many would fail when they passed the point at which they would no longer outgrow their problems.

The dramatic significance of rapid growth became even more apparent when we examined the difference in asset composition between institutions growing rapidly and the savings institutions industry as a whole. Construction lending, which historically had far greater credit risks associated with it than other mortgage lending, was accounting for less than six percent of the assets of savings institutions generally, but almost 25 percent of institutions doubling in one year or less. Acquisition and development loans -- the lending category with the highest amount of associated credit risk -- accounted for approximately two percent of savings institution assets on average but almost 13 percent for rapid growers. Direct investment in equity securities, real estate, and service corporations accounted for only about two percent of total savings institution assets, but over 10 percent for rapidly growing state-chartered institutions in California and Texas, the states with the most liberal asset authorities. Throughout 1984, direct investments by the savings institutions industry increased at close to a 100 percent annual rate. To put that number in perspective, at that rate of increase, the level of direct investments would have almost quadrupled in two years and increased sixteen-fold in four years.

Furthermore a disproportionate number of the institutions that were growing quickly were rapidly throwing their assets into areas in which they had comparatively little experience. Specific numbers are illustrative. With regard to nonresidential mortgage originations, the savings institution share of the market went from 11 percent in 1981 to 27 percent in 1984. The savings institution market share of total outstanding construction loans grew from 27 percent in 1981 to 48 percent by the end of 1984. That is, our market share had almost doubled over a base that had itself almost doubled in just several years. Interestingly, of thrift institution construction loans outstanding, about 20 percent were nonresidential three years ago versus 43 percent by the end of 1984. Total nonresidential construction loans by savings institutions were up six-fold in only three years. Obviously, a number of thrifts were taking a very rapid ride down some very steep learning curves, and obviously not everybody was landing on their feet.

Before focusing on the regulatory problems presented by these trends, it is useful to consider their broader implications. The broadest implication is that there no longer was, in a true sense, one savings institutions industry. It is common among savings institutions executives to talk aobut "the industry." What our numbers showed was that there was not one industry anymore -- but rather a number of thrift industries, each of which were developing different strategies for different purposes. The only commonality between these industries was that they had the same regulatory charter, the same insurance funds, and the same trade associations.

A second broad implication of these trends is what I will call Gresham's Law of financial institutions. Relatively speaking, it says that risk-hungry institutions will force more conservative institutions into taking greater risks as well, or equivalently, just a few institutions taking risks will force other to do the same. The notion is that ambitious depository institutions must pay interest rates high enough to sustain their desired levels of risk and rates of growth. If competing institutions want to maintain their deposit bases, no matter how conservative their instincts, they will have to pay higher interest rates as well. Simultaneously, in order to afford those higher rates, they will have to choose assets with higher expected return and greater risk than they would otherwise be comfortable with.

What it boils down to is that greater risk taken by some institutions whether advertent or inadvertent, can become a financial rip current pulling other depository institutions towards greater risk as well. As a result, by the end of 1984, we at the Board were not encouraged that the trends we were seeing in the savings institution industry would necessarily moderate in the near future.

Apart from these relatively theoretical concerns about the direction in which the savings industry was heading, we at the Bank Board had more nitty gritty reasons for worry by the end of last year.

The first and foremost implication of rapid asset growth was on the Federal Savings and Loan Insurance Corporation (FSLIC). Rapid growth was forcing the limited funds of the FSLIC to stretch over a much larger pool of liabilities. At 1984 growth rates, this would have driven the ratio of total reserves to all deposits from about seven-tenths of one percent in 1984 to a projected level below one-half of one percent by the end of 1986, even if the FSLIC had not incurred losses greater than revenues.

We also saw a disturbing shift in the underlying reasons for savings institutions failing and falling into the FSLIC's clutches. Three years ago, approximately 80 percent of the FSLIC's caseload was primarily attributable to interest rate spread problems and only 20 percent was primarily attributable to asset quality problems. By 1984, that ratio had more than completely reversed itself, with almost all of the FSLIC's serious problems arising from the disposition of failed thrifts with failed assets. At today's interest rate levels, we simply do not expect to see any significant number of failures that are due primarily to assets paying below-market interest rates. Peter Stearns, the Director of the FSLIC, will discuss these matters at greater length before this Committee tomorrow.

Apart from the direct effect on the FSLIC of rapid growth, it became clear by last year that uncontrolled asset growth and the accompanying credit problems also posed a tremendous challenge to the Bank Board's Examination and Supervision apparatus. Examiners simply cannot stay on top of an institution if every time they come in for an exam almost all of the assets they are looking at are new, many times larger, and unseasoned.

Even having an examiner listening in on every phone call and monitoring every transaction would not work. Many new loans, especially for real estate construction and development, take several years for the underlying problems to become so apparent that we would have legal justification for supervisory actions. Often, interest payments to the lender are paid for indirectly by the borrower from loan proceeds over the first several years. Short of going out and examining the borrower, there is nothing we can do to monitor that. Or, alternatively, the loan's interest is often recognized on an accrual basis, effectively camouflaging problems for a long time. Although the examination and supervision process will presumably pick up asset quality problems eventually, by that point corrective action may have proven insufficient to reverse what have become substantial losses in the interim.

Given the various trends I've outlined, at the end of 1984, the Board understood that fundamental changes were necessary. If we had let things slide without fundamental regulatory actions, we would have seen hundreds of major failures over the next several years. The need to avoid unnecessary financial losses to the FSLIC resulted in two fundamental regulations that the Board passed last January 31.

These two regulations -- the net worth/growth regulation and the direct investment regulation -- have received considerable scrutiny by a number of House and Senate Committees. Without going into the details, which many of you are already familiar with, the regulations made a number of significant changes. The net worth/growth regulation specifically: (a) pegged an institution's capital requirements to its growth rate; (b) removed from the books a number of previous regulatory practices which had basically reduced a savings institution's capital requirement the more rapidly it was growing; and (c) imposed a growth threshold of 25 percent each year, beyond which further growth required supervisory approval. The second regulation, the direct investment regulation, primarily affected state-chartered institutions by requiring supervisory review and approval of direct investments exceeding 10 percent or twice net worth. That regulation also imposed a number of diversification requirements on direct investments very similar to our loan-to-one borrower requirements.

These regulations provide only the beginning of what is necessary to ensure a sound savings institutions regulatory system in the years and decades ahead. The next set of changes required to deal with a growing and increasingly more complex savings institutions industry by and large involve legislative changes. Chairman Gray has appeared before this committee on a number of occasions arguing for a series of legislative proposals made by the Board, including granting the Board the authority to impose risk-related deposit insurance premiums, enhancing our authority over the activities of state-chartered savings institutions, buttressing our ability to launch and prevail in cease and desist proceedings against savings institutions violating the law, and giving the Board increased flexibility in regard to recruitment and compensation practices. He has made the arguments for these various proposals with such force that I simply cannot duplicate these arguments in the amount of time I have available.

I will simply say that without these changes, the ability of the Board to control the losses of the FSLIC and to maintain the integrity of an important sector of our financial system will become increasingly and needlessly difficult. The onus for initiating the next stage of financial institution regulation and deposit insurance reform rests squarely on the Congress of the United States. Without actions on your part, our ability to perform our fundamental responsibilities will become increasingly tenuous.

I do not mean to imply that that Board is adopting a position of passivity in regards to its problems until legislative changes are enacted. On the contrary, in addition to performing routine responsibilities, we have begun to focus enormous energy on reforming the examination and supervisory process so as to detect troubled loans and investments as soon as serious problems occur. In light of the fact that FSLIC-insured institutions now hold close to $350 billion in loans and investments other than traditional owner-occupied one-to-four family residential mortgages and government securities, new approaches on our part are imperative.

The crux of our efforts regarding examination and supervision must increasingly become recognizing losses earlier and dealing with them promptly. This may sound simplistic, and indeed I am glossing over some complex issues regarding appraisal practices and the correct valuation of assets that the prospect of asset write-downs inevitably give rise to. Nevertheless, it is not an oversimplification to point out that a primary responsibility of examination and supervision is simply to detect when and where losses have occurred, to measure them, and to ensure that they are properly reflected on financial institutions' balance sheets.

We are all learning with every month that delaying the recognition of losses due to poorly performing assets results in significantly higher costs, in the long run, to the federal deposit insurance funds than would occur if those costs were dealt with promptly and straightforwardly. Ironically, the prompt recognition of losses results in the minimization of losses over the longer run. The "heads I win, tails you lose" situation posed by federal deposit insurance for banks and thrifts becomes magnified when a depository institution is sliding towards insolvency. As the institution nears insolvency, the incentive to resurrect itself by significantly increasing risk becomes enormous. With little left to lose, troubled institutions tend to engage in a variety of risky transactions all the while knowing that if the risk does not pan out, stockholders and management will be little or no worse off than they would be otherwise. The challenge and responsibility of federal regulators generally, and of the examination and supervision process specifically, is to ensure that these situations are avoided, since the full onus of the accompanying losses falls upon the federal deposit insurance funds.

Efforts on our part to recognize losses when economically justified will encounter fierce opposition in some quarters. Let there be no doubt about it. Stringent supervisory practices do, ultimately, mean forcing some institutions out of business. There is always a temptation to defer financial institutions' losses by letting problem loans sit on institutions' books at original values, so that cosmetically everything can appear neat and clean. But we believe as responsible regulators and fiduciaries that we must reject this tendency.

We simply cannot allow institutions that have made major mistakes in underwriting loans and investments to continue to operate, making more of the same mistakes, all the while enjoying the federal deposit insurance sticker on the door and all of the benefits that it provides. If there is a single lesson to be learned from the growing incidence of thrift and bank failures over the last several years, it is that deferring problems almost always results in much larger problems, much sooner, than anyone ever expected.

Just as responsible and successful institutions need to be encouraged and given the widest range of opportunities, reckless institutions need to be restrained and unsuccessful institutions must be made to accept the cost of failure. This requires forcing savings institutions to recognize losses on a timely basis.

To be sure, many real estate assets underlying loans are not actively traded and precise valuation is impossible. The impossibility of precision does not, however, remove the need for supervisory actions, whether they reflect pinpoint accuracy or not. The point is that large losses should not be deferred through accounting manipulation or misrepresentation. Ultimately, poor real estate lending and investment must translate, with as little delay as possible, into the owners of a poorly performing thrift facing the loss of their franchise and the managers facing the harsh discipline of unemployment.

Undoubtedly, a criticism of the Bank Board that you may hear in the coming months as we pursue these practices is the same argument that we have heard too often in the recent past: that by taking actions to safeguard the FSLIC, we are turning our backs on the spirit and substance of deregulation.

This particular argument is so inaccurate and so distorted that I am reluctant to dignify it by acknowledging the frequency with which it occurs. Nevertheless, to set the record straight, a response is clearly required.

First, let us define what deregulation is and is meant to be. Deregulation is a continuing process of allowing financial institutions -- which historically have operated under very restrictive chartering authorities --to achieve the flexibility needed to reduce risk through the diversification of their portfolios. Deregulation is meant to strengthen financial institutions by reducing their risk. In the case of savings institutions, asset deregulation as accomplished by the Garn-St Germain Act was intended in the words of the preamble to that Act to "revitalize the housing industry, by strengthening the financial stability of home mortgage lending institutions and ensuring the availability of mortgage funds."

Now, let us agree with what deregulation is not.

Deregulation is not a license to steal.

Deregulation is not a green light for financial institutions to take on imprudent risks, with a full understanding that their bets amount to "tails, they win, heads, the federal deposit insurance agencies lose."

Deregulation is not a loosening of rules so that imprudent institutions with poor management and insufficient underwriting practices can accumulate mounting losses, without supervisory sanctions, through the misrepresentation that problem loans are worth every penny that was paid for them.

In short, deregulation in no way implies a reduction in the accountability of the owners and managers of federally insured lending institutions. If anything, the flexibility and discretion provided by deregulation increase the need for accountability dramatically.

Accountability can only become an operating reality, as opposed to a common cliche, if financial regulators exert the examination and supervision muscle needed to make accountability stick. The greatest challenge facing both the Federal Home Loan Bank Board, and I believe our sister regulators in the commercial banking system, is to catalyze the evolution of a system of examination and supervision whose agents enjoy unprecedented capabilities, competence, sophistication, and clout.

Ultimately, this can only occur if the examination and supervision of financial institutions is recognized as constituting a full-fledged profession with all of the status, the challenges, and the financial rewards accompanying a dignified profession.

Deregulation is presenting all of us -- we at the Bank Board, our fellow financial agencies, the Administration, and the Congress -- with historically unprecedented challenges. A sense of discipline, and a sense of responsibility, are more necessary now than ever before if our savings institution system, and more broadly, if our nation's financial structure is to survive in its current form.

# # #

Mr. Chairman, in a recent letter to the Federal Home Loan Bank Board, you asked a number of detailed questions regarding financial statistics of both the thrift industry generally and the FSLIC's problem caseload specifically. Your letter, and the answers to your questions, which were prepared by several of the offices of the Federal Home Loan Bank Board, are attached to my statement.

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U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

September 3, 1985

Mr. Frank Passarelli, Acting Director
Office of Examination and Supervision
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Mr. Passarelli:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the present system of federal deposit insurance, you are requested to appear before the Subcommittee on September 11, 1985, at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to testify on the financial condition of the depository institutions under the jurisdiction of your agency.

In your testimony, please provide the Subcommittee with a thorough overview of current financial conditions and respond specifically to the questions below with respect to the smaller, intermediate, and larger institutions under your agency's jurisdiction.

1. Are current levels of capital, including consideration of classified assets and off-balance sheet items, adequate? How do current capital levels compare with levels in previous years?

2. How sensitive is asset quality to national economic conditions? What is the current level of asset quality, and how has it been affected in recent decades by successive periods of recession and recovery? What are the present conditions in real estate lending, and how do they compare with those of recent years?

3. What are the current levels of institutions earnings with respect both to equity and to total assets, and how do these levels compare with those of years past?

4. How do current liquidity levels, particularly in the form of uninsured and short-term borrowed funds, compare with those of previous years? What has been the impact of the increased use of brokered deposits?

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5. What is the present number of so-called "problem institutions"? What is the amount of total deposits held by these institutions? Why has the number of "problem institutions" changed as it has in recent years? What proportion of these of "problem institutions" are institutions that are burdened only by a maturity mismatch -- the so-called "spread cases"? What proportion of the "problem institutions" are those with asset quality problems only? Is the trend in the number of "problem institutions" due mainly to shifts in national econmic conditions, to changes in the rigor of federal agency supervision, to changes in the risk of preferences of institution managers, or to the operations and premium levels of the Federal Savings and Loan Insurance Corporations? What supervisory actions are being taken in response to the trend in the number of "problem institutions"?

6. How many institutions have had to be liquidated, merged, or assisted to avert failure so far this year, and how does this number compare with those in previous years? Do you expect this trend to continue?

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B-303 Rayburn twenty-four hours in advance of your scheduled appearance before the Subcommittee. Your prepared statement will be included in its entirety in the hearing record and, if delivered as requested, your statement will be distributed to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members sufficient time for questioning, the oral presentation of your testimony must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:dDv

ANSWERS TO SPECIFIC QUESTIONS

QUESTION NUMBER 1: Are current levels of capital, including consideration of classified assets and off-balance sheet items, adequate? How do current capital levels compare with levels in previous years?

ANSWER: The Bank Board considers capital (i.e., net worth) of many FSLIC-insured institutions inadequate at the present time. One of the Board's primary goals is to facilitate and require higher net worth ratios. As a result of rapid asset growth and inadequate earnings, especially in 1981 and 1982, when the industry was experiencing operating losses, the aggregate net worth ratio of FSLIC-insured institutions has declined sharply in recent years as shown in Table 1 attached. The ratio of regulatory net worth to total assets dropped from 7.13 percent in 1970 to a low of 3.69 percent at yearend 1982. There has been some improvement since then, but at the end of March the ratio was still only 3.93 percent. The decline has been even greater if net worth is measured in terms of Generally Accepted Accounting Principles rather than regulatory standards. By such measurement--which excludes mutual capital certificates, net worth certificates subordinated debentures, appraised equity capital and deferred losses on assets sold that are included in regulatory net worth--the aggregate industry net worth ratio was only 2.96 percent in March.

Table 1

Net Worth Ratios of FSLIC-Insured Institutions
(Percent)

End of:	All	Large[1]	Intermediate[2]	Small[3]
A. Regulatory Net Worth/Total Assets				
1970	7.13	n.c.	n.c.	n.c.
1971	6.75	n.c.	n.c.	n.c.
1972	6.43	n.c.	n.c.	n.c.
1973	6.34	n.c.	n.c.	n.c.
1974	6.32	n.c.	n.c.	n.c.
1975	5.95	5.76	5.71	6.11
1976	5.73	n.c.	n.c.	n.c.
1977	5.62	n.c.	n.c.	n.c.
1978	5.66	5.55	5.60	5.94
1979	5.70	n.c.	n.c.	n.c.
1980	5.36	5.05	5.44	5.93
1981	4.35	4.01	4.42	5.26
1982	3.69	3.40	3.80	4.78
1983	4.02	3.96	3.80	4.74
1984	3.80	3.70	3.74	4.91
1985-March	3.93	3.88	3.71	4.80
B. GAAP Net Worth/Total Assets[4]				
1980	5.36	5.05	5.44	5.93
1981	4.23	3.90	4.25	5.19
1982	3.05	2.60	2.89	4.34
1983	3.14	3.10	2.64	4.08
1984	2.86	2.98	2.20	3.89
1985-March	2.96	3.11	2.12	3.78

[1] Institutions with total assets at end of period of $500 million or more.

[2] Institutions with total assets at end of period of $100 million, but less than 500 million.

[3] Institutions with total assets at end of period of less than $100 million.

[4] Regulatory and GAAP net worth ratios were identical prior to 1980. The latter exclude the following items included in the former: mutual capital certificates, subordinated debentures, net worth certificates, appraised equity capital and deferred losses on assets sold.

Note: The definition of total assets used in calculating these ratios is the one currently in effect for the entire period.

QUESTION NUMBER 2: How sensitive is asset quality to national economic conditions? What is the current level of asset quality, and how has it been affected in recent decades by successive periods of recession and recovery? What are the present conditions in real estate lending, and how do they compare with those of recent years?

ANSWER: Historically the underlying quality of thrift assets has been only moderately affected by national economic conditions. Indeed, the upward trend in real estate prices facilitated by inflationary expectations in many years had the effect of papering-over instances of poor loan underwriting. A more significant influence on asset quality has been instances of cyclical overbuilding in specific geographic areas (e.g., California and Florida in the early 1960's). Assets quality still is largely influenced by local conditions, but the sharp reduction in inflation the last few years and growth in the importance of lending on income-producing residential and commercial property and for land development by thrifts make it even more important that they appropriately analyze their lending opportunities so as to avoid lending in geographic areas or on types of property where property values, and therefore the value of their security interests, is likely to deteriorate.

QUESTION NUMBER 3: What are the current levels of institutions' earnings with respect both to equity and to total assets, and how do these levels compare with those of years past?

ANSWER: Over the last 15 years net after-tax earnings of FSLIC-insured institutions have ranged between 0.82 and -0.73 as a percentage of average assets and between 16.0 and -15.4 as a percentage of prior period net worth. Until recently, industry earnings had been at the lower end of these ranges, as shown in Tables 2 and 3 attached, but preliminary information for the second quarter of this year indicates a substantial improvement as a result of a variety of factors, including a drop in cost of funds stemming from a decline in market interest ratio. Our current best estimate of the annualized return of assets for FSLIC-insured institutions in the second quarter is in a range of 0.50-0.55 percent, while return on equity was probably in the 11-15 percent range. Such earnings would be toward the upper end of the range for recent years, and as long as market interest rates remain at current levels the prospect for continued favorable earnings is good. This will help to restore the industry's depleted net worth. In recent years, there has been no consistent correlation between earnings and size of institution, as shown in the attached tables.

Table 2

Return on Assets of FSLIC-Insured Institutions
(Percent)

Period	All	Large[1]	Intermediate[2]	Small[3]
1970	0.57	n.c.	n.c.	n.c.
1971	0.71	n.c.	n.c.	n.c.
1972	0.77	n.c.	n.c.	n.c.
1973	0.76	n.c.	n.c.	n.c.
1974	0.54	n.c.	n.c.	n.c.
1975	0.47	0.48	0.44	0.51
1976	0.63	n.c.	n.c.	n.c.
1977	0.77	n.c.	n.c.	n.c.
1978	0.82	0.91	0.79	0.81
1979	0.67	n.c.	n.c.	n.c.
1980	0.13	0.15	0.10	0.16
1981	-0.73	-0.75	-0.79	-0.62
1982	-0.66	-0.54	-0.71	-0.68
1983	0.27	0.28	0.24	0.18
1984	0.12	0.08	0.17	0.25
1985-1st Qtr.[4]	0.21	0.25	0.08	0.30

[1] Institutions with total assets at end of period of $500 million or more.

[2] Institutions with total assets at end of period of $100 million, but less than $500 million.

[3] Institutions with total assets at end of period of less than $100 million.

[4] Annualized

n.c. - not computed

Table 3

Return on Equity[1] of FSLIC-Insured Institutions
(Percent)

Period	All	Large[2]	Intermediate[3]	Small[4]
1970	8.3	n.c.	n.c.	n.c.
1971	11.1	n.c.	n.c.	n.c.
1972	12.9	n.c.	n.c.	n.c.
1973	12.9	n.c.	n.c.	n.c.
1974	9.0	n.c.	n.c.	n.c.
1975	8.1	8.4	7.8	8.3
1976	11.8	n.c.	n.c.	n.c.
1977	15.0	n.c.	n.c.	n.c.
1978	16.0	17.7	15.3	14.6
1979	12.9	n.c.	n.c.	n.c.
1980	2.5	2.8	1.7	3.0
1981	-14.3	-15.4	-14.9	-10.3
1982	-15.4	-15.0	-16.1	-12.4
1983	7.8	9.0	6.7	3.7
1984	3.3	3.3	4.7	5.3
1985-1st Qtr.[5]	5.7	6.7	2.2	6.2

[1] Net after-tax income as a percent of regulatory net worth at the beginning of period.

[2] Institutions with total assets at end of period of $500 million or more.

[3] Institutions with total assets at end of period of $100 million, but less than $500 million.

[4] Institutions with total assets at end of period of less than $100 million.

[5] Annualized

n.c. - not computed

QUESTION NUMBER 4: How do current liquidity levels, particularly in the form of uninsured and short-term borrowed funds, compare with those of previous years? What has been the impact of the increased use of brokered deposits?

ANSWER: Recent liquid asset ratios of FSLIC-insured institutions have been high by historical standards. The ratio of holdings of liquid assets eligible to meet the Bank Board's regulatory requirement to total deposits and borrowing has been around 11 percent. This is well above earlier levels, as shown in Table 4, attached. Such levels of liquidity are also well above the Bank Board's regulatory requirement. This undoubtedly reflect the desire of management to protect itself from the loss of funds that might result from their increased reliance on short-term borrowing, uninsured deposits and broker-originated deposits in recent years (see Tables 5-7, attached). Generally, however, large institutions have lower liquidity ratios, than smaller ones, despite their greater reliance on potentially volatile sources of funds.

Table 4

Ratio of Liquid Assets to Total Deposits and Borrowing All FSLIC-Insured Institutions (Percent)

End of:	All	Large[1/]	Intermediate[2/]	Small[3/]
1970	9.79	n.c.	n.c.	n.c.
1971	9.77	n.c.	n.c.	n.c.
1972	9.07	n.c.	n.c.	n.c.
1973	7.72	n.c.	n.c.	n.c.
1974	7.45	n.c.	n.c.	n.c.
1975	8.93	8.44	8.85	9.45
1976	9.58	n.c.	n.c.	n.c.
1977	8.27	n.c.	n.c.	n.c.
1978	8.13	8.14	7.93	8.53
1979	7.70	n.c.	n.c.	n.c.
1980	8.42	7.73	8.37	10.24
1981	7.90	7.21	7.88	10.06
1982	10.38	9.99	10.39	12.02
1983	11.17	10.43	11.36	13.89
1984	11.34	10.25	12.74	16.78
1985 - March	11.18	9.72	12.72	16.18

[1/] Institutions with total assets at end of period of $500 million or more.

[2/] Institutions with total assets at end of period of $100 million, but less than $500 million.

[3/] Institutions with total assets at end of period of less than $100 million.

n.c. - not computed

Table 5

Ratio of Short-Term Borrowing to Total Deposits and Borrowing
All FSLIC-Insured Institutions
(Percent)

End of:	All	Large[1]	Intermediate[2]	Small[3]
1970	n.a.	n.a.	n.a.	n.a.
1971	2.29	n.c.	n.c.	n.c.
1972	2.52	n.c.	n.c.	n.c.
1973	3.49	n.c.	n.c.	n.c.
1974	3.20	n.c.	n.c.	n.c.
1975	2.80	4.07	2.74	1.79
1976	2.09	n.c.	n.c.	n.c.
1977	3.01	n.c.	n.c.	n.c.
1978	4.34	5.16	4.00	3.49
1979	4.90	n.c.	n.c.	n.c.
1980	5.48	7.30	4.46	2.67
1981	8.60	10.84	7.38	3.82
1982	9.07	11.29	7.00	3.20
1983	7.38	9.31	4.74	2.21
1984	9.97	12.48	5.42	2.54
1985 - March	9.03	11.16	4.96	2.27

[1] Institutions with total assets at end of period of $500 million or more.

[2] Institutions with total assets at end of period of $100 million, but less than $500 million.

[3] Institutions with total assets at end of period of less than $100 million.

n.c. - not computed

n.a. - not available

Table 6

Ratio of Uninsured Deposits to Total Deposits and Borrowing
All FSLIC-Insured Institutions
(Percent)

End of:	All	Large[1]	Intermediate[2]	Small[3]
1970	2.98	n.c.	n.c.	n.c.
1971	3.15	n.c.	n.c.	n.c.
1972	4.76	n.c.	n.c.	n.c.
1973	4.59	n.c	n.c.	n.c.
1974	1.67	n.c.	n.c.	n.c.
1975	2.45	3.12	2.44	1.93
1976	3.55	n.c.	n.c.	n.c.
1977	3.93	n.c.	n.c.	n.c.
1978	4.23	5.90	3.51	2.96
1979	5.89	n.c.	n.c.	n.c.
1980	3.59	5.12	2.48	1.70
1981	3.58	4.96	2.28	1.81
1982	3.98	4.97	2.63	2.33
1983	5.83	7.33	3.51	2.55
1984	7.11	8.61	3.80	2.96
1985 - March	6.88	8.42	3.75	2.74

[1] Institutions with total assets at end of period of $500 million or more.

[2] Institutions with total assets at end of period of $100 million, but less than $500 million.

[3] Institutions with total assets at end of period of less than $100 million.

n.c. - not computed

Table /

Ratio of Broker-Originated Deposits to Total Deposit and Borrowing
All FSLIC Insured Institutions
(Percent)

End of:	All	Large[1/]	Intermediate[2/]	Small[3/]
1970	n.a.	n.a.	n.a.	n.a.
1971	n.a.	n.a.	n.a.	n.a.
1972	n.a.	n.a.	n.a.	n.a.
1973	0.08	n.c.	n.c.	n.c.
1974	0.06	n.c.	n.c.	n.c.
1975	0.05	0.05	0.06	0.05
1976	0.07	n.c.	n.c.	n.c.
1977	0.10	n.c.	n.c.	n.c.
1978	0.13	0.19	0.07	0.11
1979	0.34	n.c.	n.c.	n.c.
1980	0.69	1.25	0.23	0.10
1981	0.54	0.88	0.15	0.24
1982	1.26	1.37	0.80	1.46
1983	3.75	4.31	3.19	2.74
1984	4.66	5.81	2.23	1.85
1985 - March	4.26	5.44	1.72	1.55

[1/] Institutions with total assets at end of period of $500 million or more.

[2/] Institutions with total assets at end of period of $100 million, but less than $500 million.

[3/] Institutions with total assets at end of period of less than $100 million.

n.c. - not computed

n.a. - not available

QUESTION NUMBER 5

Question number 5 contains seven separate sub-questions, four of these (numbered 5a, 5b, 5d, and 5e below) are statistical in nature and will be answered first. The others (numbered 5c, 5f, and 5g below) are substantive questions and will be answered last. For purposes of this testimony we have defined problem institutions as those rated "4" or "5" as of their most recent examination.

QUESTION 5A: What is the present number of so-called "problem institutions"?

ANSWER: The total number of "problem institutions" is 656 financial institutions regulated by the Board.

QUESTION 5B: What is the amount of total deposits held by these institutions?

ANSWER: These problem institutions hold a total deposit amount of $198,325,702,000

QUESTION 5D: What proportion of the "problem institutions" are institutions that are burdened only by a maturity mismatch -- the so-called "spread cases"?

ANSWER: The number of institutions with spread problems only is 210 or 32% of the problem cases.

QUESTION 5E: What proportion of the "problem institutions" are those with asset quality problems only?

ANSWER: The number of institutions with asset problems is 389 or 59% of the problem cases. The remaining cases are divided between institutions with spread problems (32%) and "other" problems (9%). All of this information may be more easily seen in the following table:

	Asset Quality Problem Cases					
	Asset Only	Asset/Spread	Total	Spread	Other	Total
Number	248	141	389	210	57	656**
Percentage	38%	21%	59%	32%	9%	100%
Deposits*	67,384,219	52,489,139	119,873,358	58,562,264	19,890,080	198,325,702
Assets*	84,606,209	68,877,490	153,483,699	70,023,123	24,741,343	248,248,165

*Figures in 000's of dollars.

**Data includes only those examinations completed thru June 30, 1985.
Data as of yearend will be forwarded when available.

QUESTION 5C: Why has the number of "problem institutions" changed as it has in recent years?

ANSWER: We believe that the increase of the number of problem institutions may be traced to various sources including (1) changes in the national economy, (2) the Board's previously inadequate examination and supervisory personnel resources, and (3) the increased penchant of some thrifts to undertake high-risk investments. Also at fault, we believe, is deregulation which was meant to strengthen financial institutions by allowing them to diversify their investments and thereby reduce their risk, but unfortunately, has been seen by some thrift institutions as an opportunity to take on imprudent risks all the while assured that the FSLIC will cover their losses. [1]

The Board is aware now of the types of problems deregulation has created, and is able now to more effectively and frequently examine and monitor institution activities. We also believe these problems could be more easily controlled, in part, by allowing the FSLIC to assess higher insurance premiums on institutions which choose to undertake high-risk ventures. The Board only lacks certain legislative reforms to begin to effectively inhibit the future potential for a proliferation of problem institutions. Of course, a continuation of the current relatively low-interest rates would do much in stabilizing thrifts' problems. In our view, a favorable economic climate is a significant factor in solving the problems facing thrifts; a return of inflation and high-interest rates would again put many thrifts in peril.

QUESTION 5F: Is the trend in the number of "problem institutions" due mainly to shifts in national economic conditions, to changes in the rigor of federal agency supervision, to changes in the risk of preferences of institution managers, or to the operations and premium levels of the Federal Savings and Loan Insurance Corporation?

ANSWER: As we note above, our opinion is that a combination of unfavorable economic conditions, inadequate federal supervision powers, and high-risk investments by institutions are chiefly responsible for the proliferation of problem institutions.

Economic Factors

The thrift industry traditionally generated deposits from the local community at regulated rates of interest and invested the deposits in home mortgage loans. Failures during this period usually resulted from local economic conditions that led to deposit outflows and mortgage defaults. On occasion, fraudulent practices played a part in the failures. Once restrictions on rates paid on deposit accounts were lifted, the competition for deposits escalated immensely and thrifts were forced to pay higher rates. Diversification from home mortgage lending was needed to achieve a positive spread, and many thrifts ventured into lending on commercial properties and land development projects without adequate underwriting and appraisal standards.

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[1] The deregulation of the liability side of the balance sheet first created competitive pressures to pay higher rates. This brought about a substantially higher cost of money but without a corresponding ability to quickly move out of long-term, low-yielding investments in fixed-rate mortgage. The resultant rapid erosion of net worth created pressures, in turn, to seek investments with inordinately high yields and concomitant inordinately high risks.

Investment Risks

New powers, including commercial lending, which thrifts, and especially state-chartered thrifts, enjoy have, as noted earlier, unfortunately led to imprudent investments. Failures due to asset quality problems have increased and are on the rise exceeding those failures which are due to interest rate spread problems. While the nation's economy in general may have been held inherently responsible for initiating the woes thrifts experienced attempting to favorably match their assets and liabilities, the blame for asset quality problems may be placed directly on inexperienced or incompetent management, which, in its haste to make an institution grow. often does not take the time to thoroughly review and analyze its investment choices.

The desire of many thrifts to achieve rapid growth and delve into direct investments has resulted in many unsound investments in speculative assets which inevitably lead to a greater potential for loss. State-chartered institutions, taking advantage of broader state charter authority, have undertaken much greater risks through enhanced product and service authorities which far exceed those allowed federally chartered thrifts. Complicating the problems inherent in such high-risk transactions is the fact that deposit brokers place large sums of volatile funds into institutions which are looking to grow rapidly and the funds are too often used to acquire unsafe and unsound assets. Prior to adoption of regulations restricting excessive growth and tying it to capital requirements, the Board had no means by which to control such imprudent activities. The Board still needs the express authority to restrict FSLIC insurance of brokered deposits.

Too often the same thrifts which choose to invest in high-risk projects are those which suffer from poor underwriting and recordkeeping practices. Lack of expertise is all too common as are instances of minimal internal controls and possible conflicts of interest. Generally shoddy management practices lead to a plethora of financial woes.

Regulatory Deficiencies

Some thrifts which find themselves in trouble choose to hide their problems from the Board. Reports to the Board may be inaccurate and/or untimely. Accounting practices may be misleading. Board examiners rely on an institution's audited financial statements as part of their examination functions. Obviously, reliance on deceptive statements from purportedly reputable accounting firms and thrift institutions will lead to a far different evaluation of an institution's financial condition than that which would be obtained from verifiably honest statements.

The Board too, until recently, has been stymied in its efforts to conduct examinations on an as timely and as extensive basis as it needs.

Since the Board is no longer subject to the constraints of civil service hiring practices with regard to its field staff, and since agreements have been reached with state regulatory agencies which provide for increased examiner staffs, the likelihood of an institution becoming a severe problem case, before any detection is made of its poor condition, is less likely to occur.

Working as part of a dual regulatory system, that is, in conjunction with state examiners, the Board does rely on its counterparts to serve as the primary regulators for state-chartered institutions. State staffing levels, however, have been exceedingly low and it has been only in the last several months that efforts have been made by state regulatory authorities to correct this problem. In the meantime, examination teams from state agencies have been able to carry out their responsibilities on an even less frequent basis than the Board. Clearly, problem institutions were more likely to proliferate and, if undetected, to increase in severity when their examination and supervision was so severely limited.

Clarification of the Board's enforcement powers and its increased power to issue cease and desist or removal orders against an institution or officer, before serious losses have resulted, would also serve as an effective hedge against poor management practices.

Finally, in relation to the part of your question on the increase in problem institutions resulting from the operations or premium levels of the FSLIC, we stated earlier that while not contributing to the increase, a change to allow risk-based premiums would contribute to stabilizing the thrift industry. Incompetent or irresponsible management could be more easily controlled and brought to task if the Board were able to institute risk-based insurance premiums which would require higher premiums from institutions which choose to engage in high-risk ventures.

QUESTION 5G: What Supervisory actions are being taken in response to the trend in the number of "problem institutions"?

ANSWER: We believe there are three avenues on which the Board can proceed to control and ultimately reduce the number of problem institutions. The first is regulatory; the second, administrative; and the third, legislative.

Regulatory

The Board has proposed and instituted regulations dealing with brokered funds, adequate net worth, direct investments, excessive growth, proper accounting for acquisition, development and construction loans and sound underwriting standards.

Our regulatory authority on brokered funds is not as far-reaching as we would prefer. The courts have struck down, in large part, our regulatory limitation on FSLIC insurance coverage on brokered deposits to $100,000 per broker per institution. We have nonetheless been able to require that supervisory institutions (those which fail to meet their regulatory three percent net worth requirement) are prohibited from receiving brokered funds if such deposits exceed five percent of all deposits when aggregated with all other brokered funds and custodial deposits. Institutions with low net worth are now required to submit monthly reports disclosing their brokered deposits activity to their respective Federal Home Loan Banks. The Banks in turn report to the Office of Examinations and Supervision in Washington, D.C., the identity of the institutions required to file such reports, data filed, and any narrative necessary to describe institution activities and/or any supervisory action.

Excessive growth and questionable investments have been curbed by various regulations; one requires de novo institutions to have higher capital, maintain higher net worth and refrain from investing in service corporations or real estate in excess of 10 percent of assets for a period of three years. Newly chartered institutions therefore, may no longer be used as a vehicle for rapid growth and high-risk investments.

Another regulation now in effect to curb excessive growth is one which strengthens net worth requirements. An institution's capital requirement is now hinged on its growth rate: the faster the growth rate, the higher the net worth requirement. Additionally, the method of calculating net worth has been changed to eliminate the practice whereby the three-percent capital requirement could be met by leveraging the ratio of liabilities to net worth at excessive levels. Finally, the regulation serves to impose a permissive growth threshold of 25 percent a year; growth at a higher ratio requires prior supervisory approval.

Credit risk problems have been addressed by the Board's direct investment regulation which applies to all FSLIC-insured institutions. The regulation still allows for the exercise of state authority, but provides for supervisory review and approval of certain types of direct investments by federally insured institutions and of aggregate direct investments above certain thresholds. Included among investments addressed in the regulation are those in equity securities, real estate, service corporations and operating subsidiaries. The rule additionally requires diversification of an institution's aggregate investments in equity securities and in real estate.

Extremely risky acquisition, development and construction (ADC) "loans" which are, in actuality, investments, are now required to be booked as investments. When previously booked as loans, thrifts could record income on a current basis from loan fees and interest paid from loan proceeds. Although the

American Institute of Certified Public Accountants (AICPA) had published two notices, available to all accounting firms, which described the factors to be considered when determining the appropriate differentiation between ADC loans and investments, it was not treated as an authoritative statement of Generally Accepted Accounting Principles (GAAP), thus, some of the accounting profession ignored the ruling. As a result, the Board adopted a regulation requiring FSLIC-insured institutions to use the accounting treatment and principles for ADC loans, as set forth in the AICPA notices, when preparing financial statements for the Board or the FSLIC. Such a requirement is believed to significantly reduce the misclassification of high-risk investments as loans. The impact of proper classification is that profits, if any, cannot be recognised until the investments have been sold and the benefits actually realized.

In a rule primarily relating to interest-rate-risk management, the Board has explained that underwriting standards must be maintained to control credit risk exposure. In a proposed rule, the Board has set forth a new method for classifying commercial loans. Problem loans would be classified in categories like those maintained by our counterparts in the commercial banking industry: substandard, doubtful or loss. Specific reserves would be required at various levels for classified assets. Such reserves would be transferred from the institution's net worth accounts and would lower the amount of an institution's net worth and the attendant freedom of action higher levels of net worth afford.

Loans without appraisals and those otherwise deficient in documentation will be classified. Such a measure will effectively serve as an incentive for improved underwriting standards.

Administrative

One of the major improvements made by the Board to deal with the increased number of problem institutions has been the transfer of field examiners to the Federal Home Loan Bank System. This changeover has eliminated civil service constraints related to staffing, administrative and budgetary requirements. Moreover, it should alleviate the problem of higher turnover which resulted from low pay scales, difficult working conditions, personnel cutbacks and increased workload. The Bank employment system should assure the hiring of much-needed examiners and should attract more highly qualified individuals since the benefits associated with working for the Banks exceed those of working for the government. Additional experienced examiners on the staff will allow for more frequent examinations and more opportunity for closer scrutiny of institution records when examinations are in process.

The Board has also developed an off-site review system which provides an improved early-warning system between examinations. The computer monitoring system flags characteristics likely to lead to problems.

Excessive growth is now closely monitored and institutions which are growing rapidly are subject to increased supervisory monitoring and, if necessary, on-sight examination.

Various reforms are under consideration to improve procedures related to review of public disclosures and filings, independent audit reports and reports filed by institutions with the Board. The Board has undertaken to develop a program of industry management assistance in which highly qualified individuals temporarily serve as directors and managers of failed institutions until permanent solutions can be found. Such a program should allow for the best possible management of assets and the stabilization of liabilities which will clearly help the FSLIC fund.

Legislative

The Board recommended a legislative package to the 99th Congress which was introduced by request by Chairman St Germain in the House and by Senator Garn in the Senate. Both H.R. 1680 and S. 759 are now before the Banking Committees. While I know the Committees will give appropriate attention to the totality of these proposals, I would like to emphasize a few of our suggestions.

First, the Board seeks legislative authority to enhance our control over brokered deposits by permitting the FSLIC to establish classes of insured accounts and guaranteeing only those classes appropriate for insurance. Those accounts structured to place excessive risk on the FSLIC would not be federally insured. Such reform would curb abuses by institutions not considered to be of supervisory concern prior to their last examination and institutions desperate enough to violate regulations to stave off failure through the acquisition of brokered funds for investment in excessively risky investments.

In response to the growing number of problem institutions, the Bank Board has adopted a "get-tough" policy for institutions and individuals who violate its laws and regulations and engage in unsafe or unsound practices. As a result, the number of formal supervisory agreements, temporary and final cease and desist orders, and removal and prohibition orders against negligence or wrongdoing officials all have increased significantly in the last three years.

In addition, the Board is seeking certain legislative amendments to enable it to even better utilize the enforcement tools available to it. These amendments include a provision which would allow for the immediate issuance of a temporary cease and desist order whenever an institution's books and records are so incomplete or inaccurate that we cannot determine the financial condition of the institution. Already in effect is a regulation which requires an institution to maintain records and documents and to have such materials available for examination. The Board has stressed, in memoranda issued since promulgation of the regulation, that failure to have such documentation is a violation of the regulation, and constitutes an unsafe and unsound practice.

The Board has proposed other legislative amendments to clarify its removal authority, to lessen the existing standards for insurance of temporary cease-and-desist orders, and to define the term "unsafe or unsound practice." All of these will enable the Board to better address supervisory problems at an early stage when there is a real opportunity to prevent or reduce the losses to the institution or the FSLIC.

A very important reform which the Board seeks is a change in the insurance structure. The Board would like to assess additional premiums upon those institutions which undertake activities of a nature or to an extent not authorized for federal thrifts. Aggressive state deregulation can then be more readily dealt with and controlled by allowing the FSLIC the ability to effectively underwrite the greater risks posed by some state-chartered institutions.

QUESTION NUMBER 6: How many institutions have had to be liquidated, merged, or assisted to avert failure so far this year, and how does this number compare with those in previous years? Do you expect this trend to continue?

ANSWER: During the January-August period of 1985, the Bank Board took 24 actions to protect depositors of FSLIC-insured institutions. Seven of these were liquidations, 9 FSLIC-assisted mergers or related actions, and 8 were supervisory mergers that did not require FSLIC financial assistance. Actions taken this year were at about the same annual rate as in 1985, but considerably fewer than in 1981 and 1983 and sharply fewer than in 1982, as indicated by the following table:

Actions Taken by FHLBB to Protect
Depositors in FSLIC-Insured Institutions
(Number of Actions)

Period	FSLIC Liquidations	FSLIC-Assisted Mergers and Related FSLIC Actions	Supervisory Mergers (Without FSLIC Asst.)	Total
1980	0	11	21	32
1981	1	28	54	83
1982	1	65	189	255
1983	6	33	35	74
1984	9	17	14	40
1985(Jan.-Aug.)	7	9	8	24

Given the number of FSLIC-insured institutions identified currently as problem cases (see answer to Question 5), it would be unrealistic to expect a significant decline in the number of FHLBB protective actions over the next several years even if market interest rates continue at recent levels, and should interest rates rise sharply, the number of such actions would surely increase.

Chairman St Germain. Thank you. Now we will hear from D. Michael Riley, National Credit Union Administration, Director, Office of Programs, National Credit Union Share Insurance Fund.

Without objection we will put your entire statement in the record, and you may proceed.

STATEMENT OF D. MICHAEL RILEY, NATIONAL CREDIT UNION ADMINISTRATION, DIRECTOR, OFFICE OF PROGRAMS, NATIONAL CREDIT UNION SHARE INSURANCE FUND

Mr. Riley. Mr. Chairman, members of the subcommittee, I want to thank you for the opportunity to present the subcommittee with an update on the condition of this country's credit unions. The period in fact, 1984 and the first half of 1985 have been a time of extraordinary good news for credit unions and credit union members. With the celebration of the 50th anniversary of the Federal Credit Union Act, we witnessed a 5.1-percent increase in membership at all credit unions to over 50 million in 1984, double the previous year's rate of increase.

More than 100 new Federal chapters, adding a potential of 1.5 million members, were approved by the agency last year. Another 2.7 million persons became eligible for credit union membership through field of membership amendments. In 1984, Federal credit union shares rose by 16.1 percent to $57.9 billion, loans by 26.9 percent to $42.1 billion, and all reserves by 22.2 percent to $4 billion. These figures are outstanding in themselves but two factors make them even more remarkable.

First, this was the third consecutive year of outstanding growth. It is not uncommon to see a business or industry have 1 or 2 excellent years, but the last 3 full years have seen year-to-year growth in shares of 17.3 percent, 20.7 percent, and in 1984, 16.1 percent, for a total of 54.1 percent. Moreover, these outstanding figures were achieved in an increasingly competitive and deregulated environment for credit unions and other types of financial institutions.

Second, the numbers in 1984 were remarkably well balanced. It is not unusual for one part of an operation to show strength, but to have shares, loans and capital all with positive results is a major accomplishment by the managers and directors of credit unions.

The number of Federal credit unions reporting operating losses for 1984 was only 1,040 or 9.9 percent and losses totaled only $18.5 million. In 1980, the comparable figures were 3,950 credit unions experiencing losses of $120 million. The number of problem Federal and federally insured credit unions declined by 22 percent from 1,124 at yearend fiscal 1983 to 872 at yearend fiscal 1984.

Statistics for the first half of this year indicate continued strong growth for credit unions. Savings in Federal credit unions grew substantially, and strong gains were also made in loans, assets, and new members during the first 6 months in 1985. Based on the June 30 call reports of 10,320 Federal credit unions—and thus providing actual rather than estimated numbers—savings have grown $8.3 billion, or 14.3 percent since December 31, 1984, and now total $66.2 billion. On an annualized basis, savings are growing at a rate of over 28 percent this year.

During the 6-month period, 2 million new members joined Federal credit unions, increasing the total number of Federal credit union members by 6.5 percent. If this trend continues in the second half, the 1985 membership growth rate will more than double last year's rate of 5.1.

Lending activity at credit unions is also up, although the figures reflect a general softening in loan demand being felt at all financial institutions. For the 6-month period ending June 30, loans grew by 6.1 percent, or $2.6 billion, to $44.7 billion. This is down from a 12.2-percent growth in lending at Federal Credit Unions for the first 6 months of 1984. It should be noted, however, that lending generally picks up during the second half of the calendar year. Federal credit union assets jumped $8.3 billion, or 26 percent annualized from December 31 to June 30, 1984, and now total $72 billion. Reserves or capital have kept pace, with growth at a 20-percent rate.

Finally, the number of problem code Federal and federally insured credit unions is down to 732, 21 percent less than June 1984. The total financial costs related to mergers, liquidations and other problem cases is down to its lowest point since 1979. In terms of numbers, mergers and liquidations are at their lowest level since 1982.

In summary, Mr. Chairman, credit unions are prospering in today's deregulated and competitive environment. They are doing so by sticking to the basics which have historically served them well. That is, providing convenient personal financial services at a reasonable and fair price. Credit unions are also, and have been, ready and willing to serve the great mass of low and moderate income citizens, a significant part of the market often overlooked or abandoned by other depository institutions. As member run institutions, credit unions by and large are providing the kind of personal consumer oriented services preferred by millions of Americans.

Last, although deregulation has indeed been a factor for credit unions in recent times, I want to emphasize that deregulation for NCUA has meant more, not less supervision. Stronger supervisory activity, we believe, goes hand in hand with less regulation. To this end, we have placed more emphasis on the field and our examiner staff. During the upcoming fiscal year, we have decided to hire an additional 37 examiners and other field staff to keep our manpower at full capacity.

We will continue annual examinations and our twice a year offsite review of financial statements. We also plan to increase significantly the resources we devote to training and education of our examiners. In fact, we are projecting a nearly 100-percent increase in our agency's budget for training next year. Within budgetary restraints, we are doing our best to see that credit unions continue as safe and sound institutions in these complex and rapidly changing times.

Regarding legislation, I want to take this opportunity to thank you, Mr. Chairman, for including an extension of NCUA's conservatorship authority in your bill, H.R. 2707.

Conservatorship has proven to be a most effective and valuable supervisory tool for the NCUA Board in better ensuring the safety and soundness of credit unions. It permits us to assume control of an institution, with no interruption in service to members, until the credit union can get back on its own feet. It also prevents a dissipation of assets that could have a substantial adverse effect on that credit union's members, creditors, and the NCUSIF. Lastly, it has resulted in savings to our Share Insurance Fund which we conservatively estimate at $20 million.

The NCUA Board has found the conservatorship authority to be an essential supervisory tool. We are hopeful that the Congress will see fit to extend it, through passage of H.R. 2707 or another appropriate vehicle, on a permanent basis prior to its October 15 expiration.

I would be pleased to respond to any questions from the subcommittee.

Thank you.

[The prepared statement of Mr. Riley, on behalf of the National Credit Union Administration [NCUA], follows:]

STATEMENT OF D. MICHAEL RILEY, DIRECTOR, OFFICE OF PROGRAMS, NATIONAL CREDIT UNION ADMINISTRATION

Mr. Chairman and members of the Subcommittee, I am D. Michael Riley, Director of the National Credit Union Administration's Office of Programs. I have been with NCUA since 1972, beginning my career as an examiner. Prior to assuming my current position, I was the Agency's Regional Director in San Francisco. In my present job, I have responsibility for our Departments of Insurance, Supervision and Examination, and for the NCUA Central Liquidity Facility, the central bank for credit unions.

I want to thank you, Mr. Chairman, for the opportunity to present the Subcommittee with an update on the condition of this country's credit unions. Inasmuch as my office also encompasses insurance, I also will be back here tomorrow to outline the present state of the National Credit Union Share Insurance Fund.

The condition of credit unions is very good. In fact, 1984 and the first half of 1985 have been a time of extraordinary good news for credit unions and credit union members. With the celebration of the 50th Anniversary of the Federal Credit Union Act, we witnessed a 5.1% increase in membership at all credit unions to over 50 million in 1984 -- double the previous year's rate of increase.

More than 100 new Federal charters, adding a potential of 1.5 million members, were approved by the Agency last year. Another 2.7 million persons became eligible for credit union membership through field of membership amendments. In 1984, Federal credit union shares rose by 16.1% to $57.9 billion, loans by 26.9% to $42.1 billion, and all reserves by 22.2% to $4 billion. These figures are outstanding in themselves but two factors make them even more remarkable.

First, this was the third consecutive year of outstanding growth. It is not uncommon to see a business or industry have one or two excellent years, but the last three full years have seen year-to-year growth in shares of 17.3%, 20.7% and in 1984 16.1%, for a total of 54.1%. Moreover, these outstanding figures were achieved in an increasingly competitive and deregulated environment for credit unions and other types of financial institutions.

Second, the numbers in 1984 were remarkably well balanced. It is not unusual for one part of an operation to show strength, but to have shares, loans, and capital all with positive results is a major accomplishment by the managers and directors of credit unions.

The number of Federal credit unions reporting operating losses for 1984 was only 1,041 or 9.9% and losses totaled only $18.5 million. In 1980, the comparable figures were 3,950 credit unions experiencing losses of $120 million. The number of "problem" Federal and federally-insured credit unions (Early Warning System Codes 4 and 5) declined by 22% from 1,124 at year-end fiscal '83 to 872 at year-end fiscal '84.

Statistics for the first half of this year indicate continued strong growth for credit unions. Savings in Federal credit unions grew substantially, and strong gains were also made in loans, assets and new members during the first six months of 1985. Based on the June 30 call reports of 10,320 Federal credit unions -- and thus providing actual rather than estimated numbers -- savings have grown $8.3 billion, or 14.3% since December 31, 1984, and now total $66.2 billion. On an annualized basis, savings are growing at a rate of over 28% this year. During the six-month period, 2 million new members joined Federal credit unions, increasing the total number of Federal credit union members by 6.5%. If this trend continues in the second half, the 1985 membership growth rate will more than double last year's rate of 5.1%. Lending activity at Federal credit unions is also up, although the figures reflect a general softening in loan demand being felt at all financial institutions. For the six-month period ending June 30, loans grew by 6.1%, or $2.6 billion, to $44.7 billion. This is down from a 12.2% growth in lending at FCUs for the first six months of 1984. It should be noted, however, that lending generally picks up during the second half of the calendar year. Federal credit union assets jumped $8.3 billion, or 26% annualized from December 31 to June 30, 1984, and now total $72 billion. Reserves (or capital) have kept pace, with growth at a 20% rate.

Finally, the number of problem code Federal and federally-insured credit unions is down to 732, 21% less than June 1984. The total financial costs related to mergers, liquidations and other problem cases is down to its lowest point since 1979. In terms of numbers, mergers and liquidations are at their lowest level since 1982.

In summary, Mr. Chairman, credit unions are prospering in today's deregulated and competitive environment. They are doing so by sticking to the basics which have historically served them well. That is, providing convenient personal financial services at a reasonable and fair price. Credit unions are also, and have been, ready and willing to serve the great mass of low and moderate income citizens, a significant part of the market often overlooked or abandoned by other depository institutions. As member-run institutions, credit unions by and large are providing the kind of personal consumer-oriented services preferred by millions of Americans.

Lastly, although deregulation has indeed been a factor for credit unions in recent times, I want to emphasize that deregulation for NCUA has meant more, not less, supervision. Stronger supervisory activity, we believe, goes hand in hand with less regulation. To this end, we have placed more emphasis on the field and our examiner staff. During the upcoming fiscal year, we have decided to hire an additional 37 examiners and other field staff to keep our manpower at full capacity. We will continue annual examinations and our twice a year offsite review of financial statements. We also plan to increase significantly the resources we devote to training and education of our examiners. In fact, we are projecting a nearly 100% increase in our Agency's budget for training next year. Within budgetary restraints, we are doing our best to see that credit unions continue as safe and sound institutions in these complex and rapidly changing times.

Conservatorship

Regarding legislation, I want to take this opportunity to thank you, Mr. Chairman, for including an extension of NCUA's conservatorship authority in your bill, H.R. 2707.

Conservatorship has proven to be a most effective and valuable supervisory tool for the NCUA Board in better ensuring the safety and soundness of credit unions. It permits us to assume control of an institution, with no interruption in service to members, until the credit union can get back on its own feet. It also prevents a dissipation of assets that could have a substantial adverse effect on that credit union's members, creditors, and the NCUSIF. Lastly, it has resulted in savings to our Share Insurance Fund which we conservatively estimate at $20 million.

The NCUA Board has found the conservatorship authority to be an essential supervisory tool. We are hopeful that the Congress will see fit to extend it, through passage of H.R. 2707 or another appropriate vehicle, on a permanent basis prior to its October 15 expiration.

I would be pleased to respond to any questions from the Subcommittee.

08/10/85

CONSOLIDATED BALANCE SHEET
FEDERAL CREDIT UNIONS
FOR ALL REGIONS FOR DEC 1984 AND JUN 1985

ASSETS:	DEC 1984	JUN 1985	% CHG
LOANS TO MEMBERS	41,999,670,076	44,512,822,273	5.9
ALL OTHER LOAN ACCOUNTS	133,949,677	194,928,108	45.5
TOTAL LOANS	42,133,619,753	44,707,750,381	6.1
ALLOWANCE FOR LOAN LOSSES	298,866,669	318,794,291	6.6
CASH	1,441,600,874	1,740,207,002	20.7
INVESTMENT SECURITIES:			
U.S. GOVT OBLIGATIONS	1,795,257,834	2,476,8[illegible]7,708	37.9
FEDERAL AGENCY SEC.	3,929,764,511	4,136,037,077	5.2
COMMON TRUST INV.	420,530,206	563,515,019	34.0
CORP. CENTRAL (CD)	3,429,583,412	4,572,503,070	33.3
BANK (CERT. DEP)	2,541,241,939	3,695,727,829	45.4
S&L, MSB (CERT. DEP)	5,866,690,920	7,323,653,819	24.8
CAPITALIZATION DEPOSIT	0	366,226,824	0.0
OTHER CUS (CERT. DEP)	103,595,253	112,576,156	8.6
LOANS TO OTHER CU	15,357,360	10,974,532	28.5-
SHARES IN CLF	67,939,497	0	0.0
ALL OTHER INVESTMENTS	396,074,766	411,989,239	4.0
TOTAL INVESTMENTS	18,566,035,698	23,870,051,273	28.5
ALLOWANCE FOR INVESTMENT LOSS	19,163,236	16,922,408	11.6-
LAND AND BLDG (NET OF DEP)	762,838,463	803,996,761	5.3
OTHER FIXED ASSETS	372,542,871	415,881,218	11.6
ALL OTHER ASSETS	699,106,043	819,456,759	17.2
TOTAL ASSETS	63,657,720,771	72,021,634,262	13.1
NATURAL PERSON CREDIT UNIONS	10,548	10,320	2.1-
CORPORATE CREDIT UNIONS	17	17	
CORPORATE ASSETS	4,647,430,758	5,700,901,131	

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CONSOLIDATED BALANCE SHEET
FEDERAL CREDIT UNIONS
FOR ALL REGIONS FOR DEC 1984 AND JUN 1985

LIABILITIES	DEC 1984	JUN 1985	% CHG
PROMISSORY NOTES	72,949,044	31,460,764	56.8-
REVERSE REPO AGREEMENT	309,601,546	97,535,285	68.4-
OTHER NOTES	288,821,393	140,502,379	51.3-
ACCOUNTS PAYABLE	291,279,884	325,247,097	11.6
INT PAYABLE ON DEPOSITS	1,203,459	42,110,822	3399.1
DIVIDENDS PAYABLE	597,533,860	532,603,709	10.8-
DEPOSITS	0	0	0.0
ALL OTHER LIABILITIES	127,190,970	145,925,729	14.7
TOTAL LIABILITIES	1,688,580,156	1,315,385,785	22.1-
EQUITY / SHARES			
SHARE CERTIFICATES	12,908,554,189	13,577,780,180	5.1
SHARE DRAFTS	5,264,515,705	6,347,325,816	20.5
IRA, KEOGH ACCOUNTS	5,206,246,825	7,365,120,882	41.4
OTHER SHARES	34,548,491,981	38,953,309,403	12.7
TOTAL SHARES	57,927,810,478	66,243,537,952	14.3
REGULAR RESERVES	1,799,598,553	1,962,484,449	9.0
INVESTMENT VALUATION RESERVE	0	0	0.0
OTHER RESERVES	649,533,225	691,274,088	6.4
UNDIVIDED EARNINGS	1,592,190,768	1,808,945,512	13.6
EQUITY TOTAL	4,041,322,546	4,462,704,049	10.4
TOTAL EQUITY/SHARES	61,969,133,024	70,706,242,001	14.0
TOTAL LIABILITIES/EQUITY/SHARES	63,657,720,771	72,021,634,262	13.1
NCUA INSURED SAVINGS			
UNINSURED SHARES	364,573,153	468,644,937	28.5
UNINSURED MEMBER DEPOS	0	0	0.0
UNINSURED NON-MEM DEPOS	0	0	0.0
TOTAL UNINSUR SHARES & DEPOS	364,573,151	468,644,938	28.5
INSURED SHARES & DEPOSITS	57,563,237,111	65,774,892,807	14.2

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CONSOLIDATED BALANCE SHEET
FEDERAL CREDIT UNIONS
FOR ALL REGIONS FOR DEC 1984 AND JUN 1985

INCOME:	DEC 1984	JUN 1985	% CHG
INTEREST ON LOANS	* 5,225,917,641	2,926,523,475	12.0
LESS INTEREST REFUND	* 25,960,219	7,899,784	39.1-
INCOME FROM INVESTMENTS	* 2,047,441,272	987,430,089	3.5-
OTHER OPERATING INCOME	* 207,092,747	134,279,182	29.6
TOTAL GROSS INCOME	* 7,454,494,848	4,040,335,881	8.3
EXPENSES:			
EMPLOYEE COMPENSATION	* 839,316,323	458,838,361	9.3
EMPLOYEE BENEFITS	* 172,280,487	97,775,648	13.5
TRAVEL, CONFERENCE EXPENSE	* 40,125,079	22,155,063	10.4
ASSOCIATION DUES	* 23,973,867	14,374,594	19.9
OFFICE OCCUPANCY	* 108,632,240	61,010,076	12.3
OFFICE OPERATION EXPENSE	* 402,922,285	230,342,926	14.3
EDUCATIONAL AND PROMOTION	* 50,813,721	28,357,878	11.6
LOAN SERVICING EXPENSE	* 37,660,345	21,955,922	16.5
PROFESSIONAL,OUTSIDE SERV'S	* 169,548,893	94,860,781	11.8
PROVISION FOR LOAN LOSSES	* 164,666,957	98,628,422	19.7
MEMBER INSURANCE	* 183,122,852	72,419,792	20.9-
OPERATING FEES	* 17,808,818	8,572,710	3.7-
CASH OVER AND SHORT	* 1,676,852	853,096	1.7
INTEREST ON BORROWED MONEY	* 46,919,061	20,346,606	13.2-
ANNUAL MEETING EXPENSE	* 13,173,688	10,744,762	63.1
MISC OPERATING EXPENSE	* 40,853,488	22,271,253	9.0
TOTAL OPERATING EXPENSE	* 2,313,509,898	1,263,520,949	9.2
INCOME FROM OPERATIONS	* 5,140,982,997	2,776,813,325	8.0
NON-OPERATING GAINS OR LOSSES			
GAIN (LOSS) ON INVESTMENTS	* 4,873,950-	10,372,838	525.6
GAIN (LOSS) ON DISP OF ASSETS	* 2,601,319	958,412	26.3-
OTHER NON-OPERATING INCOME	* 7,668,784	7,204,916	87.9
TOT INC (LOSS) BEFORE DIVIDENDS	* 5,146,379,032	2,795,349,589	8.6
TRANSFER TO REG & STAT RESERVES	* 259,777,402	130,211,519	0.2
DIVIDENDS	* 4,412,207,538	2,421,432,402	9.7
INT ON DEPOSITS	* 0	2,313	0.0
NET INCOME (LOSS)	* 474,391,460	243,701,574	2.7

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CONSOLIDATED BALANCE SHEET
FEDERAL CREDIT UNIONS
FOR ALL REGIONS FOR DEC 1984 AND JUN 1985

MISCELLANEOUS INFORMATION	DEC 1984	JUN 1985	% CHG
DELINQUENT LOANS BY MONTHS DELINQUENT			
	NUMBER OF DELINQUENT LOANS		
2 TO < 6 MONTHS DELINQUENT	206,412	198,513	3.8-
6 TO 12 MONTHS DELINQUENT	101,066	108,523	7.3
12 MONTHS & OVER DELINQUENT	124,139	117,135	5.6-
TOTAL DELINQUENT LOANS	431,617	424,171	1.7-
	AMOUNT OF DELINQUENT LOANS		
2 TO < 6 MONTHS DELINQUENT	445,348,023	453,664,495	1.8
6 TO < 12 MONTHS DELINQUENT	182,001,768	210,263,198	15.5
12 MONTHS & UP DELINQUENT	200,995,148	205,293,236	2.1
TOTAL DELINQUENT LOANS	828,344,939	869,220,929	4.9
LOANS GRANTED AND CHARGED OFF			
NUMBER OF LOANS MADE	* 13,374,654	6,687,814	0.0
AMOUNT OF LOANS MADE	*32,572,682,961	16,178,113,729	0.6-
NUMBER RE LOANS MADE	* 81,077	45,996	13.4
AMOUNT RE LOANS MADE	* 1,058,888,524	657,911,337	37.8-
LOANS CHARGED OFF	195,650,145	115,559,695	40.9-
RECOVERIES ON LOANS	44,780,038	25,108,237	43.9-
SAVINGS INFORMATION			
NUMBER OF ACCOUNTS $100,000 & UP	10,358	11,747	13.4
AMOUNT OF ACCOUNTS $100,000 & UP	1,241,777,573	1,610,779,206	29.7
TOTAL SAVINGS AMOUNT	57,927,810,478	66,243,537,952	14.3
BROKERED DEPOSITS			
NUMBER OF CUS REPORTING	18	50	177.7
AMOUNT OF BROKERED DEPOSITS	18,476,028	39,537,322	113.9

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CONSOLIDATED BALANCE SHEET
FEDERAL CREDIT UNIONS
FOR ALL REGIONS FOR DEC 1984 AND JUN 1985

MEMBERSHIP DATA	DEC 1984	JUN 1985	% CHG
NO. CURRENT MEMBERS	28,194,049	30,030,666	6.5
NO. POTENTIAL MEMBERS	64,826,524	67,430,117	4.0
NUMBER OF CREDIT UNION EMPLOYEES			
NO. OF FULL-TIME	47,816	50,281	5.1
NO. OF PART-TIME	14,045	1,735	87.6-
ASSETS AND LIABILITIES WITH WITH MATURITIES IN EXCESS OF 1 YEAR			
INVESTMENTS WITH MATURITY > 1 YEAR	4,624,112,524	5,464,821,711	18.1
LIAB & EQTY WITH MATURITY > 1 YR	2,136,275,102	2,768,796,754	29.6
INVESTMENTS IN AND LOANS TO SERVICE ORGANIZATIONS			
NUMBER OF CUS WITH INV OR LOANS	304	326	7.2
NUMBER OF CUS WITH A MAJORITY INT	133	157	18.0
AMOUNT OF INV OR LOANS	28,643,391	35,771,614	24.8

SELECTED RATIOS BASED ON DEC 1984 & JUN 1985 DATA

RATIO DESCRIPTION	DEC 1984	JUNE 1985
GROSS INCOME TO AVG ASSETS		5.9
DIVIDENDS & INTEREST TO AVG ASSETS		3.5
EXPENSE (LESS INT & PLL) TO AVG ASST		1.6
RESERVE TRANSFER + PLL TO AVG ASSETS		0.3
NET INCOME TO AVG ASSETS		0.3
NET INCOME TO GROSS INCOME	6.3	6.0
EXPENSES TO GROSS INCOME	31.0	31.2
DIVIDENDS TO GROSS INCOME	59.1	59.9
LOAN INCOME TO AVG LOANS		6.7
INVEST INC TO AVG INVEST		4.6
LOANS TO TOTAL SAVINGS	72.7	67.4
DELINQ LOANS TO LOANS	1.9	1.9
DELINQ LOANS TO RESERVES & A.L.L.	39.4	38.1

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NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

September 5, 1985

Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance and
Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman St Germain:

Thank you for your letter of August 1.

Pursuant to that letter and to subsequent discussions with your staff, the National Credit Union Administration is pleased to provide the Subcommittee with the attached data on credit union operations.

Please let us know if we may be of further assistance.

Sincerely,

P.A. Mack, Jr.

P. A. MACK, JR.
Vice Chairman

PAM:dl

Enclosure

ATTACHMENT B
PAGE 1 OF 14

ITEM #1

NUMBER AND TOTAL DEPOSITS (SHARES) OF "PROBLEM" ORGANIZATIONS

Year	Number	Deposits (Millions)
6/30/85	732	$3,821
1984	872	$4,071
1983	1,124	$4,652
1982	1,192	$4,590
1981	1,174	$2,980
1980	1,018	$2,400
1979	1,020	$2,300
1978	825	$1,450
1977	660	531
1976	830	570

"Problem" organizations are defined as codes 4 and 5 federal credit unions and federally insured state-chartered credit unions

The above data is reported as of fiscal year-end - September 30.

NOTE: All data throughout the report is combined for federally chartered credit unions and for federally insured state-chartered credit unions

ITEM #2

NUMBER AND TOTAL DEPOSITS (SHARES) OF ORGANIZATIONS FAILED OR ABSORBED TO AVERT FAILURE

Year	Liquidations		Assisted Mergers/ Purchase & Assumptions	
	Number	Amount of Shares (Millions)	Number	Amount of Shares (Millions)
6/30/85	26	$11.7	54	$41.8
1984	38	$34.8	100	$190.2
1983	50	$10.0	212	N/A
1982	160	$39.9	182	N/A
1981	251	$78.6	100	N/A
1980	239	$60.0	63	N/A
1979	169	$19.0		
1978	168	$14.2		
1977	142	$12.7		
1976	128	$7.5		
1975	153	$5.5		
1974	100	$2.8		
1973	50	$1.4		
1972	4	$0.002		
1971	0	$0		

Numbers of assisted mergers and purchase and assumptions were not identified separately from unassisted mergers until 1980

The above data is reported as of fiscal year-end - September 30. The data for June 30, 1985, is for a 9-month period.

ITEM #3

PRIMARY CAPITAL AS A PERCENTAGE OF TOTAL ASSETS

Year	Percentage
6/30/85	6.82
1984	7.07
1983	6.86
1982	7.24
1981	6.98
1980	6.40
1979	6.66
1978	6.25
1977	6.05
1976	6.30
1975	6.56
1974	7.00
1973	8.96
1972	9.23
1971	9.66

As nonprofit cooperatives, credit unions do not have "capital." However, for purposes of this report and in order to be somewhat consistent with the reporting of the other agencies, capital in credit unions is defined as all reserves and retained earnings and does not include shares.

ITEM #4

PRIMARY CAPITAL LESS CLASSIFIED ASSETS AS A PERCENTAGE OF TOTAL ASSETS

Year	Percentage
6/30/85	6.46
1984	6.68
1983	6.39
1982	6.66
1981	6.40
1980	5.76
1979	6.06
1978	5.78

See the definition of primary capital under item 3. Classified assets are defined as 50 percent of loans 6 to 12 months delinquent and 75 percent of loans in excess of 12 months delinquent. Loan delinquency by age category is not available prior to 1978.

ITEM #5

PRIMARY CAPITAL LESS CLASSIFIED ASSETS AS A PERCENTAGE OF TOTAL ASSETS, INCLUDING STANDBY LETTERS OF CREDIT AND OTHER OFF-BALANCE SHEET ITEMS

The figures for this item would be the same as item #4. Credit unions do not have standby letters of credit or other significant off-balance sheet items.

ITEM #6

CLASSIFIED ASSETS AND NONPERFORMING ASSETS AS A PERCENTAGE OF TOTAL ASSETS

Year	Percentage
6/30/85	.58
1984	.61
1983	.74
1982	.93
1981	.91
1980	1.03
1979	.96
1978	.77

For purposes of this report, nonperforming assets are considered to be all loans in excess of 6 months delinquent.

ITEM #7

CLASSIFIED AND NONPERFORMING ENERGY LOANS, AGRICULTURAL LOANS, INTERNATIONAL LOANS, AND REAL ESTATE DEVELOPMENT LOANS AND INVESTMENTS, EACH AS A PERCENTAGE OF PRIMARY CAPITAL

Credit unions are consumer oriented and their lending activities are concentrated primarily in consumer-type loans. There are no international loans or real estate development investments. We are not aware of any significant amount of energy loans or real estate development loans. We are beginning to experience some problems with credit unions in the farm belt whose fields of membership are dedicated primarily to the farm community.

Agriculture loans and real estate development loans are not separately identified on our call reports, but we will begin obtaining this information during the next call report period.

ITEM #8

PURCHASED FUNDS AND BROKERED DEPOSITS, EACH AS A PERCENTAGE OF TOTAL ASSETS

Year	Percentage
6/30/85	.4
1984	1.0
1983	.8
1982	.9
1981	1.9
1980	2.3
1979	4.8
1978	6.2
1977	5.3
1976	4.3
1975	3.9
1974	4.1
1973	3.7
1972	2.3
1971	2.3

The percentages listed above represent borrowed funds. There have been some isolated incidents of brokered funds received by credit unions, but this does not seem to be a widespread occurrence. Brokered funds activity was reported by credit unions for the first time on the December 1984 call reports, but the information was subsequently found to be inaccurate - overstated. The data reported would have resulted in a figure of less than .1 percent.

ITEM #9

NET INCOME AS A PERCENTAGE OF EQUITY CAPITAL AND NET INCOME AS A PERCENTAGE OF ASSETS

Year	Net Income to Capital	Net Income to Assets
6/30/85	16.32*	1.11*
1984	17.28	1.22
1983	13.30	.91
1982	14.12	1.02
1981	14.89	1.04
1980	8.02	.51
1979	13.04	.87
1978	17.61	1.10
1977	16.79	1.02
1976	17.60	1.11
1975	15.71	1.03
1974	17.64	1.23
1973	12.93	1.16
1972	13.03	1.20
1971	12.63	1.22

Net income is before reserve transfers.

The same definition of capital is applied here as in item #3.

*Annualized

ITEM #10

SUPPLEMENTAL INFORMATION

NUMBER AND TOTAL DEPOSITS (SHARES) OF PROBLEM CREDIT UNIONS AS A PERCENTAGE OF TOTAL INSURED CREDIT UNIONS

Year	Number as % of Total	Deposits as % of Total
6/30/85	4.9	4.0
1984	5.7	4.5
1983	7.1	5.8
1982	7.2	6.7
1981	6.9	5.2
1980	5.9	4.4
1979	5.8	4.8
1978	4.8	3.3
1977	4.0	1.4
1976	5.1	1.9

See item #1 for definition of problem credit unions.

ITEM #10

SUPPLEMENTAL INFORMATION

GENERAL DATA

Year	Number of Credit Unions	Number of Members	Assets (Millions)	Shares (Millions)
6/30/85	14,916	43,940,144	$106,785	$96,703
1984	15,193	43,356,240	$92,846	$84,254
1983	15,877	41,076,615	$81,961	$74,186
1982	16,435	39,298,832	$69,572	$62,976
1981	16,963	38,413,265	$64,490	$57,796
1980	17,350	36,856,813	$60,962	$54,732
1979	17,507	37,008,329	$54,928	$47,703
1978	17,121	34,739,247	$51,417	$44,119
1977	16,632	29,421,785	$43,451	$37,333
1976	16,276	26,297,210	$35,095	$30,354
1975	15,777	23,747,455	$28,814	$24,973
1974	15,146	21,068,652	$22,754	$19,562
1973	14,344	18,496,398	$18,902	$16,332
1972	14,023	16,615,748	$15,811	$13,843
1971	13,510	14,626,447	$12,598	$10,891

ITEM #10

SUPPLEMENTAL INFORMATION

ANNUAL GROWTH RATES FOR ASSETS AND SHARES

Year	Assets	Shares
6/30/85	30.0% *	29.6% *
1984	13.3%	13.6%
1983	17.8%	17.8%
1982	7.9%	9.0%
1981	5.8%	5.6%
1980	11.0%	14.7%
1979	6.8%	8.1%
1978	18.3%	18.2%
1977	23.8%	23.0%
1976	21.8%	21.5%
1975	26.6%	27.7%
1974	20.4%	19.8%
1973	19.5%	18.0%
1972	26.4%	27.1%

These figures are based on aggregte amounts in all federally insured credit unions and may be impacted by credit unions entering or leaving the federal share insurance system.

*Annualized

ITEM #10

SUPPLEMENTAL INFORMATION

NUMBER OF MAJOR PROBLEM CASE CREDIT UNIONS

Year	Number
6/30/85	50
1984	72
1983	113
1982	124
1981	114
1980	59
1979	30
1978	12
1977	9
1976	10
1975	5
1974	4
1973	20
1972	0
1971	0

These figures represent the number of operating credit unions with outstanding assistance from the National Credit Union Share Insurance Fund. These are the most severe problem cases and represent the highest degree of risk to the Insurance Fund.

Chairman **St Germain**. Thank you.

Both the Federal Reserve and Comptroller report that off-balance sheet items are growing at very rapid rates.

Mr. Taylor, or Mr. Patriarca, what is the current rate of growth of off-balance sheet items?

Mr. Taylor first.

Mr. **Taylor**. Mr. Chairman, I think that the growth in off-balance sheet items, certainly as it relates to the data that we collect, would show that the bulk of this growth is centered in the larger organizations—let's say the top 25 organizations. The level of standby letters of credit is approximately $110 billion. In the top 16 banks, money center banks, it is about $100 billion. That represents a growth rate of approximately triple since 1980.

Chairman **St Germain**. Are these the only off-balance sheet items for which you have growth rates?

Mr. **Taylor**. Yes; They are the only numbers I have available with me today.

Chairman **St Germain**. Do you have any other data that would be available if you were to consult with your various sophisticated, state of the art and exceptionally effective computers and computer operators?

Mr. **Taylor**. Yes, Mr. Chairman, we would be happy to review our full data base and provide you with a complete list of what we have. We are concerned with the increase in the level of contingent risk, and now have under consideration specific plans to deal with that risk. There is a certain level of off-balance sheet risk that has traditionally been assumed by the banks but we think it has grown to the point that that amount above the norm ought to carry with it a capital requirement.

Chairman **St Germain**. Mr. Patriarca.

Mr. **Patriarca**. Mr. Chairman, our figures are about the same as Mr. Taylor's. In terms of annual growth rates on standby letters of credit, it looks like in 1982, 31 percent; 1983, 20 percent; and 1984, 23 percent.

Standby letters of credit comprise the largest single category of off-balance sheet activity. That is the only significant off-balance sheet activity for which we have multiyear data because, quite frankly, off-balance sheet activities are blossoming faster than we can get them included in the call report and know specifically what the numbers are out there.

Chairman **St Germain**. But you do feel, do you not, that it is important to keep informed in this area?

Mr. **Patriarca**. Absolutely.

Chairman **St Germain**. Particularly because, as you say, of the multiplicity of off-balance sheet items that are coming along?

Mr. **Patriarca**. Yes, sir, and not only informed, but I think that all the banking agencies are in agreement that there has to be a capital price exacted for those off-balance sheet activities.

Chairman **St Germain**. Is it fair to state that none of the banking agencies have estimates for the growth of balance obligations, at this point in time. Does anyone dispute that?

Mr. **Taylor**. No.

Mr. **Patriarca**. No.

Chairman **St Germain**. Mr. Patriarca, or Mr. Taylor, what is the past experience of your agencies with these very rapidly growing banking activities as far as losses are concerned?

Mr. **Patriarca**. It depends on what the activities are. The standby letter of credit business has traditionally been a reasonably low-risk business because the standby letters of credit were used to back up municipal securities and municipalities presented very low credit risk in most instances. They also served as backup for commercial paper lines of major U.S. corporations. As a consequence, the standby letter of credit business has been one that to date has not proved highly risky.

However, although there is not an explicit formulation in the capital guidelines for standby letters of credit, they are treated the same as if they were loans during the examination process. They are examined, the credit quality is determined, and if they should be classified, they are classified. If there is a poor credit quality on a standby letter of credit, the bank has either to charge it off or create a reserve against it.

Mr. **McKinney**. If they are classified, are they then required to have offsetting balances? If you classify one as bad, what do you do on the other side of the sheet? Our banks that deal with our citizens take your line of credit from Mastercharge and consider that an outstanding obligation of yours, even though you only used 10 percent of it.

Mr. **Patriarca**. If it is classified, it is added into the balance sheet. A standby letter of credit is a contingent obligation of the bank, but if there is a problem with it, the bank is required to create a reserve against it.

Mr. **Taylor**. If we classify it, we require that, in computing the amount of reserve necessary to backstop the risk in your portfolio, an amount be added to cover the off-balance sheet risk.

Chairman **St Germain**. Mr. Shumway, the Federal Reserve, the Federal Home Loan Bank Board, and the National Credit Union Administration have provided the subcommittee with precise reports on the current—as of June 30, 1985—problem institutions under their jurisdiction, and the volume of deposits held by those institutions.

You tell us only that there are more than 1,000 banks on the problem list. Exactly how many are there on the problem list?

Mr. **Shumway**. Mr. Chairman, we were not aware we were being asked for absolutely current information. We can get that for you. The current number is approximately 1,035.

Chairman **St Germain**. 1,035. Thank you. My time has expired. Mr. Annunzio.

Mr. **Annunzio**. Thank you, Mr. Chairman.

My commendation to you for having these hearings. I have tried to attend all of the field hearings. In these field hearings, I found that the problem is not so much with the insurance, but the quality of the examinations made by the regulators as far as these banks are concerned, and the different standards applied by various institutions on the collateralization of a loan. If the average citizen in my district were to make application for a loan, you know, they would have to undress in public, and make sure they had enough collateral. These loans were made without proper collateralization.

I think that the fault, as most of us I feel all agree, is not insurance, but it is regulation, supervision, proper examination, proper collateralization of the loan, and closer scrutiny of the activities that go on in a bank. When I came to this committee our insurance limit was $25,000. I remember trying to raise it to $50,000. I can recall the opposition—the ABA opposing the $50,000 insurance in those days—and we settled for $40,000. The only reason we got the $40,000, by the way, is that a bank in California folded right when we were marking up the bill, and when the bank folded, the ABA changed its position, and we got $40,000. Some years later the Senate, in a conference, increased the limit because again banks in California and other Western States wanted a higher rate of insurance, and we insured deposits to $100,000.

This is why we don't have double the amount of failures in this country, because of the faith the American people have in that $100,000 insurance. Although we have not fully publicized the fact that once the insurance fund is drained, it is drained, and even the $100,000 doesn't come. But we haven't advertised that too much, you see, and there hasn't been that much loss.

Now, there is some loss. For instance, the Golden Pacific National Bank, those poor people that lost their money. It was not the $100,000 of certificates that they lost, it was this other fake certificate that they signed that wasn't legal, you see. That is where they lost their money. But anybody whose deposits have been insured up to $100,000, they have been paid, to my knowledge.

Over at Penn Square at those hearings, we had people losing $1 million testify before the committee, but up to $100,000 was safe. Whatever strength is left in our banking system, as far as banks, thrifts, and credit unions are concerned, and as far as I am concerned, is because of the faith of the American people in the insurance system that we have.

And, Mr. Chairman, I wanted to express that I feel we have a good insurance system, and deposits should be insured up to $100,000. But I do want to stress, as far as the regulators are concerned, that you just have not been doing—well, I don't want to be so blunt—but a good job. Had you done a good job at Continental on examinations in my own city of Chicago, what happened would not have happened. You just didn't do a good job.

In the case of a lot of these institutions that have gone under, the examiners did not do a good job on the examinations. I see that my time is up. I commend all of you for the information you brought to the subcommittee today.

Chairman St Germain. Mr. Wylie.

Mr. Wylie. Thank you, Mr. Chairman.

Mr. Shumway, the great bulk of the FDIC insured banks that failed or merged in 1984 were State-chartered nonmember banks, 55 out of the total of 79 that you gave me. In other words, they accounted for two-thirds of the assets involved. Why was this preponderance of State nonmember banks in this category?

Mr. Shumway. I can't answer that specifically other than to say—of course, the State nonmember banks make up the largest proportion of the banks of this country. Out of 15,000 banks, approximatley 8,000 to 9,000 are State nonmember banks, about 5,000 are national banks, and about 1,000 are State member banks. It is difficult to draw conclusions from any one specific year. But I would suspect it is due more to the breakdown in the classes of banks.

Mr. WYLIE. It doesn't have anything to do with permissiveness in State charters?

Mr. SHUMWAY. I would think not. I think the supervision is relatively consistent among the Federal agencies, and, of course, even the State-chartered banks, the insured ones, are all supervised by at least one Federal agency.

Mr. WYLIE. Mr. Hemel, you indicate in your statement that the failure of any thrifts in 1984 is due to the poor quality of assets, right?

Mr. HEMEL. Yes, sir.

Mr. WYLIE. That, in turn, is attributable to the permissiveness of charters to S&L's in certain States.

Mr. HEMEL. Of the 1984 failures——

Mr. WYLIE. I am trying to determine if there is any relationship between the failure of the chartered commercial banks and the chartered S&L's.

Mr. HEMEL. As you may know, we had to do a lot of analysis of that sort in justifying the direct investment regulation which the Board promulgated last January. And our conclusion was that while the problem was primarily prospective in nature, we were starting to see a statistically significant correlation between those problems.

Mr. WYLIE. You mentioned California and Texas in particular.

Mr. HEMEL. I mentioned those as States with liberal asset authority.

Mr. WYLIE. Can you provide us with the failure rate of State versus federally chartered thrifts?

Mr. HEMEL. Sure, we would be glad to.

Mr. WYLIE. I would ask that be provided for the record.

Chairman ST GERMAIN. Without objection.

[In response to the request of Congressman Wylie, the following information was subcommittee for the record by Mr. Hemel:]

Actions Taken by Federal Home Loan Bank Board to Protect Depositors in FSLIC-Insured Institutions

	1985*	1984	1983	1982	1981	1980
UNITED STATES	37	36	73	255	82	32
Alabama	--	--	1	1	2	1
Alaska	--	--	--	--	1	--
Arizona	--	--	--	--	1	--
Arkansas	--	--	1	15	2	--
California	9	1	1	6	5	1
Colorado	--	--	--	--	--	--
Connecticut	--	--	--	2	--	--
Delaware	--	--	--	1	--	--
Dist. of Col.	1	--	--	1	1	1
Florida	1	--	--	11	6	2
Georgia	--	1	2	8	3	1
Hawaii	1	--	--	--	1	--
Idaho	--	--	--	--	--	--
Illinois	4	3	10	43	8	[illegible]
Indiana	--	--	6	1	4	--
Iowa	--	2	1	2	1	2
Kansas	1	--	--	2	2	1
Kentucky	--	1	3	9	1	1
Louisiana	5	--	5	9	4	--
Maine	1	--	--	3	--	--
Maryland	--	1	--	4	3	--
Massachusetts	--	--	--	3	--	--
Michigan	--	--	1	3	1	1
Minnesota	--	--	1	2	1	--
Mississippi	1	2	--	4	--	--
Missouri	--	--	6	4	6	2
Montana	1	--	--	1	--	--
Nebraska	--	--	--	2	--	--
Nevada	--	--	--	--	--	--
New Hampshire	1	--	--	1	--	--
New Jersey	--	1	1	17	2	1
New Mexico	--	--	2	1	1	1
New York	--	2	3	14	7	7
North Carolina	--	--	--	4	3	--
North Dakota	--	1	--	1	--	--
Ohio	3	3	8	12	2	2
Oklahoma	--	--	--	3	--	--
Oregon	1	--	--	2	3	1
Pennsylvania	--	3	9	22	2	1
Rhode Island	--	1	--	1	--	1
South Carolina	--	--	1	3	--	1
South Dakota	--	1	2	1	1	--
Tennessee	3	7	1	4	3	2
Texas	1	4	3	20	1	--
Utah	1	--	--	--	--	--
Vermont	--	--	--	--	2	--
Virginia	1	1	3	4	1	--
Washington.	1	--	--	2	--	--
West Virginia	--	--	--	2	--	--
Wisconsin	--	--	2	3	--	1
Wyoming	--	--	--	--	--	--
Guam	--	--	--	--	--	--
Pureto Rico	--	1	--	1	1	--
Virgin Islands	--	--	--	--	--	--

*Through August

Note: Includes liquidations, FSLIC-assisted mergers, supervisory mergers without FSLIC-assistance, and management consignment cases. The data contained in this table supersedes that provided in the answer to Question 6 of Chairman St Germain that accompanied the written statement. These data include management consignment cases, which had not been included in the earlier answer, and also reflect several minor amendments.

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Actions Taken by Federal Home Loan Bank Board to Protect Depositors in FSLIC-Insured Institutions

	1980	1981	1982	1983	1984	1985*
Federal Institutions						
Liquidations	0	0	0	2	3	5
FSLIC-Assisted Mergers	4	19	48	19	9	8
Management Consignment Cases	--	--	--	--	--	3
Supervisory Mergers (Without FSLIC assistance)	10	37	114	18	11	6
Total	14	56	162	39	23	22
State-Chartered Institutions						
Liquidations	0	1	1	4	6	3
FSLIC-Assisted Mergers	7	8	17	13	4	4
Management Consignment Cases	--	--	--	--	--	7
Supervisory Mergers (Without FSLIC assistance)	11	17	75	17	3	1
Total	18	26	93	34	13	15
Total Institutions						
Liquidations	0	1	1	6	9	8
FSLIC-Assisted Mergers	11	27	65	32	13	12
Management Consignment Cases	--	--	--	--	--	10
Supervisory Mergers (Without FSLIC assistance)	21	54	189	35	14	7
Total	32	82	255	73	36	37

*Through August

Note: The data contained in this table supersedes that provided in the answer to Question 6 of Chairman St Germain that accompanied the written statement. These data include management consignment cases, which had not been included in the earlier answer, and also reflect several minor amendments.

Federal Home Loan Bank Board
October 1985

Mr. **Wylie**. I wonder if we could also have a breakdown of the problem institutions by States?

Mr. **Hemel**. Certainly.

Mr. **Wylie**. Could I have that from you, too, Mr. Shumway, for the record?

Mr. **Shumway**. I will attempt to get that, yes.

Mr. **Wylie**. Thank you, sir.

Chairman **St Germain**. That should be readily available, Mr. Shumway.

Mr. **Shumway**. I assume so.

Chairman **St Germain**. I am going to have you go to school——

Mr. **Wylie**. He won't have any trouble supplying it for the record, Mr. Chairman. Thank you.

[In response to the request of Congressman Wylie, the following information was submitted for the record by Messrs. Hemel and Shumway:]

4 AND 5-RATED INSTITUTIONS
BY STATE: 1982 - 1984

STATE	1982 NUM	1982 $ MILL ASSETS	1983 NUM	1983 $ MILL ASSETS	1984 NUM	1984 $ MILL ASSETS
AK	1	117	0	-	0	-
AL	9	1,310	8	813	9	1,683
AR	7	751	11	2,360	12	3,141
AZ	5	7,427	2	3,614	2	5,057
CA	35	32,732	34	38,644	40	58,353
CO	5	322	7	787	11	1,674
CT	11	1,214	9	1,176	8	1,596
DC	5	2,242	4	2,115	4	2,483
DE	1	102	1	200	3	1,160
FL	26	14,879	29	14,203	30	19,212
GA	20	3,713	25	4,244	21	3,892
GU	1	54	1	61	0	-
HI	3	2,293	4	2,279	4	2,376
IA	11	1,032	10	863	14	2,539
ID	0	-	0	-	1	465
IL	66	11,742	55	14,327	69	19,271
IN	24	2,952	16	2,037	20	2,799
KS	11	1,800	14	2,002	15	2,942
KY	10	1,599	9	1,729	10	1,883
LA	36	3,394	30	3,148	29	4,129
MA	7	1,355	10	1,655	8	2,168
MD	10	1,526	9	1,549	8	1,709
ME	4	335	6	454	4	420
MI	10	10,542	6	846	10	7,425
MN	8	5,641	4	2,059	6	742
MO	31	9,792	25	8,107	27	9,736
MS	10	203	12	391	11	335
MT	3	168	3	207	3	203
NC	9	1,332	5	685	7	2,313
ND	2	891	3	1,101	1	209
NE	8	3,134	11	4,347	7	4,575
NH	1	105	4	295	3	255
NJ	37	11,588	38	13,660	36	15,691
NM	9	553	7	630	7	590
NV	1	96	1	28	1	42
NY	27	13,874	23	13,459	20	19,858
OH	61	13,366	56	14,876	51	14,475
OK	5	268	2	386	9	1,284
OR	6	4,169	6	1,305	8	3,508
PA	43	8,933	36	7,824	39	8,616
PR	6	2,458	5	2,218	5	2,779
RI	2	120	2	145	3	3,268
SC	8	2,453	7	2,969	7	2,430
SD	8	340	7	326	7	407
IN	17	838	21	1,121	14	817
TX	51	8,441	48	12,980	78	28,055
UT	5	3,267	7	3,674	7	1,878
VA	24	3,096	21	4,179	21	5,785
WA	8	1,514	8	2,539	11	3,358
WI	9	923	10	2,320	7	1,126
WV	2	240	3	331	7	1,173
WY	1	10	3	392	3	474
TOTALS	720	201,252	678	201,683	738	280,385

4 AND 5-RATED INSTITUTIONS BY STATE: JUNE 30, 1985

	-----JUNE 1985----	
STATE	NUM	$ MILL ASSETS
AK	0	-
AL	8	1,604
AR	12	3,605
AZ	2	5,430
CA	38	50,015
CO	6	1,834
CT	4	742
DC	3	2,219
DE	2	243
FL	29	20,799
GA	12	3,136
GU	0	-
HI	3	1,964
IA	16	2,755
ID	1	486
IL	72	20,976
IN	21	2,462
KS	12	2,109
KY	10	2,683
LA	29	4,214
MA	3	592
MD	7	1,655
ME	4	394
MI	11	9,495
MN	9	1,337
MO	27	6,428
MS	9	285
MT	3	194
NC	6	2,501
ND	1	195
NE	4	4,064
NH	2	192
NJ	30	9,521
NM	6	690
NV	1	52
NY	13	11,919
OH	47	14,390
OK	8	942
OR	9	3,654
PA	29	7,223
PR	5	2,857
RI	3	3,381
SC	6	1,523
SD	6	349
IN	15	961
TX	66	23,373
UT	5	1,360
VA	18	5,876
WA	8	2,916
WI	6	1,029
WV	7	1,203
WY	2	401
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TOTALS	656	248,248

4 AND 5-RATED INSTITUTIONS BY CHARTER: 1983 - 1985

	State	Federal	Mutual	Stock
June 30, 1985				
Number	285	371	419	237
$ Assets (mill)	114,286	133,962	123,478	124,770
Dec. 31, 1984				
Number	335	403	468	270
$ Assets (mill)	134,423	145,962	136,776	143,609
Dec. 31, 1983				
Number	316	362	489	189
$ Assets (mill)	87,592	114,090	133,272	68,410
Dec. 31, 1982				
Number	349	371	530	190
$ Assets (mill)	74,368	126,883	143,959	57,292

Mr. WYLIE. On the other hand, Mr. Riley, you are referring to a favorable trend as far as credit unions have been concerned. There have been a decline in the number of problem cases, right?

Mr. RILEY. Yes, sir.

Mr. WYLIE. Is there a lesson to be learned here by the banks and savings and loans?

Mr. RILEY. Banks and savings and loans are entirely different than credit unions. I will say that the personal service that credit unions offer seems to be serving us well during these times.

Mr. WYLIE. Now, there is a difference. That wasn't really a very fair question. Mr. Patriarca, on page 10 of your written testimony, you mention "whether a bank's capital level is adequate depends on the level of risk." And on page 22, you mention some of the factors to be taken into consideration. Could you tell us somewhat more of the progress of this study? Where do you see the main difficulties arising?

Mr. PATRIARCA. Mr. Wylie, it is——

Mr. WYLIE. I specifically would like you to talk in terms of interest rate risks and credit risks.

Mr. PATRIARCA. The idea behind the risk-based capital study that we are doing is to identify the relative riskiness of each of the various lines of business in which banks engage and to assign a capital requirement against each of those lines of business in accordance with its risk. You can rank the lines of business on the basis of historical data and say, for example, that the commercial lending business is inherently riskier than lending on a credit card basis, which is riskier than holding Treasury securities. But the difficult part comes in trying to quantify the price that should be attached to each of those activities. Notwithstanding the difficulties, we hope to come up with a concrete proposal.

Mr. WYLIE. I guess what I am suggesting is a study would be very helpful to this subcommittee obviously. Where are we on the progress of the study?

Mr. PATRIARCA. We are shooting for an end-of-the-year completion of the study and development of a proposal.

Mr. WYLIE. Thank you. My time has expired. Thank you very much, Mr. Chairman.

Chairman ST GERMAIN. Mr. Barnard.

Mr. BARNARD. This question may have been asked, but I might repeat it. CAMEL-rated institutions, are they on the increase or decrease? Mr. Taylor?

Mr. TAYLOR. They are on the increase.

Mr. BARNARD. Primarily because of agricultural loans and energy loans? Are the increases coming in these particular areas?

Mr. TAYLOR. Yes, sir. Especially among the smaller banks where, as I indicated before, we have had strength historically. We have some farm problems and a number of those on the problem list have risen sharply.

Mr. BARNARD. Mr. Patriarca, are you having the same experience?

Mr. PATRIARCA. Yes, sir.

Mr. BARNARD. Mr. Shumway.

Mr. SHUMWAY. Yes.

Mr. **Barnard**. So the CAMEL-rated institutions are increasing but are in a specialized area?

Mr. **Shumway**. Yes. Were it not for the agricultural banks coming onto the list, the list actually would be declining.

Mr. **Barnard**. Mr. Hemel, what about FSLIC—I mean, Home Loan Bank Board—savings and loans, are they increasing or decreasing?

Mr. **Hemel**. I would defer to my colleague.

Mr. **Passarelli**. Yes, sir, they are increasing.

Mr. **Barnard**. Is this because of a specialized loan consideration or a special condition of the savings and loan industry?

Mr. **Passarelli**. I can't say exactly what would cause the increase.

Mr. **Barnard**. I thought that Mr. Hemel's oral statement—I haven't had a chance to read his written statement—was to indicate that the savings and loan industry generally was improving.

Mr. **Hemel**. What I said in my statement was that profitability on the whole was increasing, that the attributes of FSLIC insolvencies were changing, and that they are now primarily due to asset quality problems as opposed to spread problems. That doesn't mean there aren't a lot of institutions with spread problems with seriously weakened capital bases. But, in today's rate environment, they may very well pull through.

Mr. **Barnard**. Mr. Patriarca, tell me the status of nonbank banks. Are you having any—do you notice any particular trend of those institutions? Are they remaining strong, are they showing some weakness?

Mr. **Patriarca**. Mr. Barnard, we have not detected any particular divergence in the quality of their condition versus other banks.

Mr. **Barnard**. Mr. Shumway, would you have the same response to that?

Mr. **Shumway**. Yes.

Mr. **Barnard**. Mr. Taylor? You don't have any though, do you, Mr. Taylor? If you do.

Mr. **Taylor**. We do not.

Mr. **Barnard**. Mr. Shumway, I notice that the FDIC has proposed some disclosure regulations, and which I will say at the outset I endorse as far as disclosing the management of institutions that are not conforming to some of your regulations and your corrections. Is that having any effect?

Mr. **Shumway**. We have not actually started it yet. That regulation will become effective the first of the year. At that time we will begin disclosing all our final enforcement actions against problem banks.

Mr. **Barnard**. I would like to ask this question to all of you across the board. All of you have indicated that you have in place new regulations, closer supervision and closer examination. Does this in any way decrease the necessity for us to move fast on deposit insurance reform, or is what you are doing, is it giving Congress more time? Mr. Taylor?

Mr. **Taylor**. Mr. Barnard, I really don't know exactly how to answer that. I tend to think that our efforts to beef up supervision are appropriate under any circumstances, and the policy questions as they relate to deposit insurance or risk based asset measures should continue at least at the same pace. I don't think it alters that.

Mr. **Barnard**. Mr. Shumway.

Mr. **Shumway**. I tend to agree with Mr. Taylor. I think the reforms that have been proposed are important and ought to be dealt with as quickly as possible, but our intensified supervisory efforts don't really have any bearing on that.

Mr. **Patriarca**. Mr. Barnard, I think there are some good proposals for deposit insurance reform, especially giving the FDIC streamlined authority to revoke deposit insurance. I think that will be useful under any set of circumstances.

Mr. **Hemel**. None of the measures we are talking about are mutually exclusive, and I think there is reason to act quickly.

Mr. **Barnard**. Mr. Riley, I didn't mean to leave you out, but my time has expired.

Chairman **St Germain**. Ms. Kaptur.

Ms. **Kaptur**. Thank you, Mr. Chairman.

I would like to review industry conditions again. I was trying to look through the testimony and from each of the gentlemen from the Comptroller and Federal Home Loan Bank Board, I don't think the gentleman, Mr. Riley from the National Credit Union Administration had any problems. But could the other two of you summarize for me the number of problem institutions in category four or five on your respective lists for this year and how that compares to last year and what your projection for next year is?

Mr. **Patriarca**. I can give you the number of four and five-rated institutions that are in the national banking system. The number is 198 as of yearend 1984.

Ms. **Kaptur**. What is the asset total? I am really looking for a trend here.

Mr. **Patriarca**. The trend is up over last year. I am sorry, I do not have a number for last year. I am reluctant to predict that the number has peaked. In fact, I am told that the number of four- and five-rated banks is currently 261.

Ms. **Kaptur**. That is for 1985?

Mr. **Patriarca**. That is at present.

Chairman **St Germain**. That is an awful fast rate of growth.

Ms. **Kaptur**. My goodness, that one is off the chart. Do you have the total assets of those institutions?

Mr. **Patriarca**. It is in the vicinity of $100 billion.

Ms. **Kaptur**. $100 billion. All right. What about the Bank Board?

Mr. **Passarelli**. Yes; they have been on the increase. In 1984, there was 1,024. These are four- and five-classified institutions. As of June, there is 1,067.

Ms. **Kaptur**. And what is your instinct as to the future?

Mr. **Passarelli**. I can't predict what the future may be. I really can't say. In other words, what has happened, there seems to be a stabilizing of the number. It was 1,024; now it is 1,067. It seems like it is starting to stabilize.

Ms. **Kaptur**. What about Mr. Shumway? You presented some figures in your testimony for the number of failed banks. What do you anticipate?

Mr. **Shumway**. The failed banks last year was around 78, I believe. This year we have 79 at the current time. We expect the number this year to be in the vicinity of 100. We won't be surprised to see that level next year.

Ms. **Kaptur**. As you look at the value of those institutions, what are we talking about in terms of assets? I forgot that for the Federal Home Loan Bank Board. What is the dollar amount?

Mr. **Hemel**. Probably in the area of $300 billion, a third of the industry.

Ms. **Kaptur**. $300 billion?

Mr. **Hemel**. Keep in mind, we don't rate exactly to the same standards of the bank. Cross comparisons are deceptive. Using our rating system, it would be about a third of the industry.

Mr. **Shumway**. For 1984, the total assets of banks that failed was $3.5 billion exclusive of Continental. This year I do not have the number. I can get that for you. It would be substantially lower this year. We haven't had any large banks.

Ms. **Kaptur**. All right, that would be helpful information.

[In response to the request of Congresswoman Kaptur, the following letter was received from the FDIC on behalf of Mr. Shumway:]

FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20429

Office of Congressional Relations and Corporate Communications

SEP 16 1985

September 16, 1985

Honorable Marcy Kaptur
House of Representatives
1228 Longworth House Office Building
Washington, D. C. 20515

Dear Congresswoman Kaptur:

On Wednesday, September 11, 1985, Mr. Robert Shumway, Director of the FDIC's Division of Bank Supervision, testified before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, concerning deposit insurance reform. During that hearing you asked if we could supply you with the number representing the amount of total assets of closed banks for 1985.

For the period ending September 12, 1985 there were 79 closed banks. These banks had total assets when closed of $1,948,377,000.

We appreciate your interest in deposit insurance reform. Please let us know if we can be of further help.

Sincerely yours,

Loren Hooper
Legislative Attorney and Advisor

Ms. **Kaptur**. I wanted to ask the two gentlemen to comment here, Mr. Hemel and Mr. Patriarca, you both seem to disagree, your respective institutions, on the appropriate type of insurance or risk-based alternatives that we might adopt. Mr. Patriarca, you prefer the risk-based capital approach as opposed to risk-based insurance approach, and I wanted each of you to explain why you don't agree with the other one's position.

Mr. **Patriarca**. We do not oppose a risk-based deposit insurance assessment; we simply believe a risk-based capital assessment is superior. With risk-based deposit insurance premiums institutions assessments are based on their report card at the end of the year. It is an after-the-fact assessment, after the bad loans, if there are bad loans, are on the books. In the case of a risk-based capital approach, the cost of doing business in each individual line of business is identified up front, and banks are assessed on the basis of the kinds of businesses they engage in. In the event a bank chooses to hold high-quality liquid assets, for example, capital requirements would be less under that scheme of things. The advantage I see is enabling banks to identify and price their products according to the cost of capital. I think that is a more rational way of approaching the business of banking than on the basis of what a bank's classified assets turn out to be at the end of the year.

Mr. **Hemel**. We are asking for authority to impose risk-based premium. We already have the authority to impose risk-based capital requirements. One of the problems we have in the S&L industry is so many institutions are below or close to their capital requirements that raising capital requirements based on risk won't necessarily offer much additional disincentive to those institutions. For a certain segment of the industry we think risk-based premium would be more effective.

We did pass a regulation last January which to some extent did impose a risk-based capital requirement in that we took institutions with a certain direct investment portfolio and imposed a capital surcharge on them. I don't think there is any clash of principles here.

Ms. **Kaptur**. Thank you very much.

Mr. **Shumway**. If I might comment, because we also proposed a risk-related premium system, I don't see that and the risk-related capital requirement as contradictory at all. I think they can be complementary. It seems to me that the Risk-Related Capital Program requires that a bank supply capital that would be commensurate with the risk it is undertaking. It may be a good bank or bad bank, but the risk-related premium, as Mr. Patriarca said, is based on results so that a bank in bad shape would have to pay a higher premium, which I think is appropriate.

Ms. **Kaptur**. Thank you very much. My time has expired.

Chairman **St Germain**. Mr. McKinney.

Mr. **McKinney**. In reading your testimony, Mr. Hemel, I thought I was listening to one of my old speeches about the fact that the failure rate is much higher in States such as Texas and California where State legislatures are very liberal in granting powers. What would be the opinion of the Federal Home Loan Bank Board—since the deposit insurance is Federally backed—if Congress simply stated that there are certain practices of thrifts that we are not going to insure. For example, if you have crude tankers, tuna boats, windmill farms, or garbage collection services.

Mr. **Hemel**. Our position is favorable. Our legislative proposal does include measures that would help us achieve that, so there is no disagreement.

Mr. **McKinney**. You know, gentlemen, throughout all of your testimony, and during my experience of 16 years on this committee, we always come back to the problem being the bank's assets. It has been the same problem in each case starting with Penn Square and continuing through Continental Illinois and the San Marino S&L out in Los Angeles. Isn't there some way, in all of the regulations we have of the banking industry, we can get a better handle on the quality of assets before the fact? I sat through the hearings on Penn Square and Continental Illinois. I had a difficult time figuring out why whistles weren't blowing all over Chicago at that $10 million that went into Penn Square in 5 months. We don't seem to be able to keep our regulatory process in any of the agencies on top of the asset problem before the failure.

I would like any or all of you to comment on that. There is never any question whether or not my bank has the assets. I signed my house over, and they drive by and look at the house and say, "Uh-huh, uh-huh, it is still there." But they are also very quick to call me up and say, "The real estate market is falling, we are not going to give you collateral on that thing."

Mr. **Taylor**. I fully agree with all the problems talked about in the banking business. To the degree people in corporations that borrow the money have the ability to repay it. The rest of this stuff would be pretty minuscule.

As it relates to what we are going to do, I think the improvement that would help is that in the major organizations we can't really rely upon a once-in-a-while examination to follow the asset quality. I think we are going to have to supplement full examinations with periodic target reviews and visits to ascertain if there has been a shift in the portfolios. Also I think it is time we started to collect information that targets more specifically on the risk and the change in the risks that are in the portfolios.

Mr. **McKinney**. One of the things that has always interested me about this is there doesn't seem to be any correlation in regulators' review on money going into an area, like Penn Square and oil speculation, and the tremendous amount of it that rings a bell and says danger. In other words, don't put all your eggs in one basket.

Mr. **Patriarca**. I share your concern, and that is something we have been working on. We have developed an Industry Review Program where we require banks to identify concentrations in terms of 70 or 80 different industries. We have contracted to get all sorts of fancy analyses of these various industry segments so that we can identify when there is going to be a problem in timber or mining, or whatever. We then match that against the list of banks that have a concentration in those particular areas and get over to the banks and see that they do something about it before the world comes to an end. I wish we had that program in place in 1981, and I wish we had known the oil glut was going to happen.

Mr. **McKinney**. Mr. Hemel?

Mr. **Hemel**. Again, I will defer to my colleague.

Mr. Passarelli. We established a monitoring device to be aware of any increase in the activity, any particular type of investment in these associations, as well as the growth in savings and deposits and borrowings. That kind of a monitoring device is based on reports submitted by the associations. We use that device as a means to alert us to any possible problems. And then, as a result of that, we send examiners into the associations to actually review that activity to see if there is anything of concern to us.

Chairman **St Germain.** Thank you very much.

Ms. Oakar.

Ms. Oakar. Thank you, Mr. Chairman.

With respect to the FDIC fund and the FSLIC fund, we have seen a number of financial institutions go under. I think my colleague from Ohio pointed out that 79 banks failed, the most since the Depression. We don't like to be alarmists because we know the confidence of consumers is very, very important.

I wonder if any of you would care to comment on what conditions in both the S&L industry and the banking industry you feel led up to that and why do you fail to monitor these banks properlly? There must have been some failure, as my colleague from Illinois pointed out, in scrutiny—in a real sense many of you have authority there. What did you do wrong? Why do we have this devastating number of failures of S&L's and banks? Mr. Shumway?

Mr. Shumway. I might just start out by saying while the numbers are large and they are much larger than they have been in the past, as I pointed out earlier, they still are not tremendously excessive when you relate them to the total number of banks. There are 15,000 banks in the country and 80 or 100 is ½ less than 1 percent. So it really isn't as excessive as perhaps has been portrayed.

Nevertheless, it is disturbing, and I think the factors that led up to it are very diverse. The most important ones, we think, are economic factors. The last 4 or 5 years have been very turbulent. We have had a couple of significant recessions, we have had a transition from an inflationary economy to a noninflationary economy, we have had a drop in the price of oil, a significant drop; we have a tremendous problem in the agricultural area——

Ms. Oakar. Didn't we have similar problems before? You could talk about any decade having problems of that magnitude. What about the scrutiny involved in looking at these institutions? Do you think that could be beefed up somewhat?

Mr. Shumway. I certainly do. I think we all feel we can and are improving our supervisory procedures. We do an analysis, and I am sure the other agencies do, of every bank that fails. We look at the last few years of the bank, we look at what supervisory procedures were followed, and we attempt to determine where our weaknesses were.

Ms. Oakar. In view of the fact there have been so many institutions that have gone under, what has this done to the FDIC fund?

Mr. Shumway. Actually the fund has increased throughout this entire period. We have been able to absorb heavy losses entirely from income. We have not had to touch the FDIC's principal during that entire period, and the fund has grown significantly.

Ms. **Oakar**. The FSLIC balance was 0.82 percent of the insured deposits. They have always ranked between 1 and 2 percent in the past. How do you account for that drop, Mr. Hemel? Isn't that a little alarming that we don't have a higher percentage? What would you recommend that we do about that? Or what are you doing about that?

Mr. **Hemel**. First of all, as far as the reason for the drop, most of the reason for the drop is growth in the base as opposed to reduction in the insurance fund. As I point out in my testimony, in 1983 and 1984, the industry was growing at a rate where it doubled in less than 4 years.

Ms. **Oakar**. You still have to insure——

Mr. **Hemel**. I understand. You are asking what the reason was. I am saying by and large, it was the growth in the denominator as opposed to reduction in the denominator.

As far as what to do about it, I guess that is one of the focuses of these hearings. We clearly need, in addition to doing our own job, a number of things from you, including enhanced authority, and increased flexibility regarding compensation and recruitment of personnel. I can't underscore enough the importance of the latter. We can speak about all the new things we are doing and how great it is, but if we can't attract and retain the right people to do it, those are just words, and nothing more.

Ms. **Oakar**. What do you mean, attract and retain the right people? You can't get the right people——

Mr. **Hemel**. Doing things well requires talent. And I think it is common knowledge that almost all of the Federal agencies are having a very difficult time attracting and retaining talent. That does not mean we don't have some; we do.

Ms. **Oakar**. That is right. In view of the fact the administration proposes minus 5 percent pay increases, we can understand why not everybody is flocking to the Federal Government to be career employees.

But let me just ask you one quick question. Are you in favor of seeing all S&L's federally insured providing they meet the regulations?

Mr. **Hemel**. We are quickly heading to a world in which that is the case.

Ms. **Oakar**. Would you like to see that happen so you don't have to be bothered by Maryland's crisis or Ohio's?

Mr. **Hemel**. I think we are on the record in saying for reasons of public confidence we thought that was a fairly important development.

Ms. **Oakar**. Mr. Shumway, in view of the fact banks want to diversify on all these other things besides banking, do you think that is going to help their financial stability, or is it going to hurt the stability?

Mr. **Shumway**. I think that some diversification within certain constraints will help their financial stability, it will give them additional sources of income, more diversified sources of income, and the net effect will be an improvement, yes.

Ms. **Oakar**. Thank you. Thank you, Mr. Chairman.

Chairman **St Germain**. Mr. Roemer.

Mr. **Roemer**. Thank you, Mr. Chairman.

I thank you gentlemen for your testimony. I came late, and am going to leave early, but I did want to ask a question if you will stick with me just a minute. I know you accurately said you can't predict the future, but part of your business is to look ahead.

In looking ahead, we have talked this morning about agricultural problems, and what it does to various institutions. I would like you to think about the foreign lending problem, Latin America and elsewhere. How do you take that into your calculations about future effect? I have read stories written by people much more knowledgeable than myself, much more talented than myself, who speak of future impending problems with that foreign debt.

Is that a factor in your analysis of the future, and would you address that for me? Beginning with you, Mr. Taylor, or Mr. Shumway.

Mr. TAYLOR. Mr. Roemer, we do look at the future, and we do try to anticipate as it relates to the foreign lending question, there probably are additional difficulties out there. The level to which those difficulties prevail and effect the banking system, I think, in large part are going to be a result of how we deal with it.

Just like with our farmers, to the extent we deal with them and liquidate everybody, we are going to have a big loss. To the extent we work with them and understand the difference between liquidity problems and solvency problems, I think we will probably do all right. As it relates to how much, generally whether we are through the hump, whether there will be more problem banks, you know, we tend to have the hope that we are going to be on the decline.

Mr. SHUMWAY. I can't add too much to what Mr. Taylor said. We also try to look into the future, and we think the problems in the international lending area are not over by any means. They still are very disturbing. I would not attempt to prognosticate.

Mr. ROEMER. Did you happen to read an article in the Wall Street Journal about a month ago by Felix Rohatyn in regard to the international monetary system, the impending or the threat of, in his opinion, the international debt, particularly central Latin South America, pointing out those nations actually owe more today than they did 3 years ago during which time we solved the problem, the fact that there is far in excess of $100 billion in a limited handful of banks in this country of obligations there, the interest of which is not being paid now?

Did you happen to read that article? That sparked my question. I wonder if you do that kind of impending doom analysis in your various organizations.

Mr. PATRIARCA. At the Comptroller's Office, as at our sister agencies, we do future analyses—I won't call it impending doom analyses—with respect to foreign debt. The kind of analysis we do is really rather traditional since we treat a loan from a U.S. bank to a company or farmer in a foreign country absolutely the same as if it were to a farmer in Iowa or anywhere else in this country. If there is a problem with it, it is classified, and the bank must reserve against it.

As regards transfer risk, the risk that a country whose currency is different from ours will not be able to get enough dollars to repay bank loans, I think there are legitimate grounds for continuing concern. We are aware of the risks, and they are among the reasons that we have been vigorously encouraging banks to increase their capital and their reserve positions.

Mr. **Roemer**. You are not comfortable, I take it, and I don't want to put words in your mouth. And maybe you don't want to address this, I can understand that, but I take it that you are not comfortable with the combinations of threats to safety and soundness.

I could talk about agriculture; it's been talked about. I could talk about the foreign debt situation. Do I exaggerate when I ask you if you are comfortable about the near future?

Mr. **Patriarca**. You don't exaggerate. We are uncomfortable, but I think that is why we are here. I do not think you would want regulators comfortable about threats to safety and soundness.

Mr. **Roemer**. Does anyone want to comment on the question on safety and soundness and your feeling of comfort or discomfort as the case may be? Are we exaggerating this problem? Are we underestimating this problem?

Mr. **Patriarca**. I do not think the situation is one of doom and gloom. I do not think we are on a precipice, but there is legitimate ground for concern.

Mr. **Roemer**. I thank you. I yield back my time.

Chairman **St Germain**. You didn't yield much.

Mr. Roth.

Mr. **Roth**. Thank you, Mr. Chairman.

Mr. Hemel, in your opening statement, you mentioned that there is a certain onus, a certain obligation Congress has. You touched on that in answer to one of the questions from the lady from Ohio. Can you go over those steps that you want Congress to do?

I know one of them is to beef up your staff. What are the other points you made?

Mr. **Hemel**. We have a long and complicated legislative package here. Among other things we have also asked for is the authority to impose a risk-related deposit premium. We have also asked for essentially legal changes that would make it easier for us to prevail in cease-and-desist proceedings.

We have asked for provisions that would make it easier for us to regulate the service corporation activities of State-chartered institutions, and the list goes on. I think those are probably the major or general categories of our legislative proposal. I might add——

Mr. **Roth**. Continue. I'm sorry.

Mr. **Hemel**. You mentioned the need for increased flexibility in getting and keeping good people.

Mr. **Roth**. There is no way Congress can draft legislation that is going to cover all of the variables, to address every eventuality that would arise. It would seem to me management in these institutions must bear more of a responsibility.

Do we have any type of a standard for the people in management, the people making the loans and so on? That is the front line of where these problems are either solved or commenced.

Mr. **Hemel**. For example, one rationale to make it easier for us to win in cease and desist proceedings is so we can remove bad management. And I believe there are provisions in the package that would certainly help us do that. One of our frustrations is even when we see people who are bad managers by any standard, our hands are tied.

Mr. **Roth**. Are there any qualifications for the managers? Can anyone—can Cooper or Roemer become loan officers down at the S&L?

Chairman **St Germain**. Even Roth?

Mr. **Roth**. Or even Roth?

Mr. **Hemel**. We would welcome them. Let me ask——

Mr. **Roth**. The point I am trying to make is this: and I think it is a valid point. If you are going to sell a corner lot here in Virginia or the District or anywhere else, you have to have a real estate license. You have to have an escrow account. You have to have continuing education. But as a loan officer you need no qualifications whatsoever except maybe 21 or 18 years old.

Mr. **Hemel**. I would have to ask our local expert here.

Mr. **Passarelli**. We have standards for a de novo institution. We ask for the qualifications of the people at that time. But in existing institutions we don't establish any qualifications.

Mr. **Roth**. It seems to me with all the problems you have maybe what we need are some qualifications for these people. There is no way we are going to be able to pass enough laws to cover every variable, every possible incident that we can conceive of.

Mr. **Hemel**. Congressman, I have two graduate degrees from an esteemed university. Unfortunately, I am not convinced those sorts of credentials qualify people to be good and prudent lenders.

I wish they did. It would make life a lot easier.

Mr. **Roth**. Mr. Shumway, with our experience with the Garn-St Germain Act of 1982, what are some of the changes you think we should be considering, if any?

Mr. **Shumway**. One I can think of is that Garn-St Germain would allow us to deal, on an interstate basis, with a bank over $500 million in assets, but only in a failed bank situation. One of the changes we are suggesting is that it also applies to a failing bank situation where the bank is not necessarily closed.

There may be others.

Mr. **Patriarca**. May I offer a suggestion? As it presently stands, a failed bank is dealt with on a per bank basis depending on an asset size test. I think the deposit insurance funds could be helped immeasurably if in States which do not allow branching but instead have multibank holding companies an out-of-State acquirer were able to acquire all of the holding company subsidiaries rather than the failing bank alone. The subsidiary that is failing is not the attractive piece of business in that new State, it is the fact that the multibank holding company owns other banks that are not failing. I think the price the FDIC could get would be a lot better if the whole holding company could be acquired.

Mr. **Roth**. Thank you very much. Thank you, Mr. Chairman.

Chairman **St Germain**. Mr. Cooper.

Mr. **Cooper**. Thank you, Mr. Chairman.

Mr. Shumway, I was just wondering if you had explored the idea or knew of any reference materials that might have explored the idea of, assuming we don't do away with broker deposits, of actually charging those institutions which broker the deposits, for the use of being able to sell that insured deposit to a customer.

I realize the deposit insurance is intended to benefit the person who has the money in the bank, but it seems to me these institutions derive substantial benefit from being able to market these deposits and advertise them, being able to place these deposits around the country.

Are you familiar with any idea or research on a topic like that?

Mr. **Shumway**. I agree they do derive a benefit. We have explored a lot of different ideas, but I am not sure that one has come up. It may be workable but I don't think we have explored it.

Mr. **Cooper**. I would ask you, if you did have the time or the inclination, to explore that sort of user fee concept, it seems to me if an institution derives a substantial benefit from a government activity, it might help increase the solvency of your fund.

It may be an idea that is beneficial for all concerned.

Mr. **Shumway**. We will certainly look into it.

Mr. **Cooper**. Mr. Patriarca, I like the idea of prefailure takeovers. It does seem hard to draw an objective line, though, when you can step in. I hear a lot of complaints, as you know, Tennessee has had a record number of bank failures the 3 years I have been in office, no causal relationship, but it does seem to be hard, because even a clearly failed institution will have those who say, look, if you had just given us another year, another month——

Can you suggest right now any objective criteria we could use to draw that line?

Mr. **Patriarca**. We are drawing a line now at 3 percent. When a bank's capital gets down to 3 percent, we write a letter to the FDIC saying they ought to revoke its insurance.

Mr. **Cooper**. If you applied that line S&L's—won't most of the S&L's——

Mr. **Patriarca**. Insurance——

Mr. **Cooper**. So it is a standard that from the very beginning can't be applied across the board to all financial institutions. It is an inherent double standard.

Mr. **Patriarca**. That is correct. The capital positions of the respective industries are double standards.

Mr. **Cooper**. Mr. Hemel, I was intrigued by your report yesterday considering floating $20 billion in bonds. I was wondering how you are going to pay back the interest on those bonds?

Mr. **Hemel**. Well, that article was fundamentally inaccurate, so there isn't a plan of that sort. I have an official statement addressed to that article. I can read it now if you would like.

Mr. **Cooper**. You are saying the Wall Street Journal reporter was wrong?

Mr. **Hemel**. I think the implications of the article were inaccurate.

Mr. **Cooper**. Could you outline for me, Mr. Hemel, the personnel trends? I realize you need more personnel to do the examination work. Has the number of personnel declined or stayed the same in the last 4 or 5 years?

Mr. **Hemel**. I don't have the exact numbers with me. It is increasing somewhat now. I do want to emphasize that while quantity is a problem, attracting or training quality personnel is as much if not more of a problem.

We can provide those numbers for the record, though.

[In response to the request of Congressman Cooper, the following information was submitted for the record by Mr. Hemel:]

Staffing level for FHLBB Examinations Staff

Fiscal year:	*Number of examiners and first level supervisors*
1980	700
1981	736
1982	729
1983	680
1984	695
1985 [1]	679

[1] Prior to transfer of staff to the Federal Home Loan Banks on July 6. Staffing has increased substantially since then.

Mr. COOPER. You indicated, I believe, in your answer to the questions of the chairman there are about 656 problem institutions, yet we read so many places one-third or more of the industries is insolvent or under your net worth standards.

Isn't there kind of a double standard there? It is tempting for me to accuse you all of fudging the number of problem institutions and minimize that number so the public won't be unduly alarmed or so that your regulatory folks won't be overtaxed in trying——

Mr. HEMEL. I don't understand your question.

Mr. COOPER. You said there are 656 problem institutions, but a lot of observers would have the number higher than the——

Mr. HEMEL. There are about 600 institutions below regulatory net worth. We alluded to 1,000 institutions who get four or five ratings in our rating system; clearly a significant fraction of savings industries have not done well over the last 5 years.

Mr. COOPER. I don't want to go too far, but it seems like there might be a policy of you all underreporting the number of real problem institutions and also not forcing the hand of a lot of institutions that should be declared dissolvent.

Mr. HEMEL. There is certainly no attempt at underreporting. As far as forcing the hands, we need more powers from you to help us do that. We do it when we can, but that doesn't mean we do it as much as we would like to.

Mr. COOPER. You also need more insurance money so you can pay off the deposits of those who have failed, don't you?

Mr. HEMEL. That's another issue all together, but that is not a constraint at this point in time.

Mr. COOPER. Thank you, Mr. Chairman. My time has expired.

Chairman ST GERMAIN. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman, and I would like to followup on the gentleman from Tennessee's line of questioning.

In the questions that you have answered to the subcommittee, you say there are 656 financial institutions in trouble. The total amount of deposits these institutions hold is $198 billion, and the total amount of assets they control is $248 billion. That's all on your chart. What number of institutions would actually have to go under for the FSLIC to run out of money, average size?

Mr. HEMEL. That would depend on a number of variables regarding timing, our effectiveness at putting in replacement management, interest rates, stated and real estate priced.

Mr. SCHUMER. Let's take the trend for the last year, based on the institutions that you actually had to come in and bail out. How much did these bailouts cost you?

Mr. **Hemel**. How much did those institutions cost us?

Mr. **Schumer**. Yes.

Mr. **Hemel**. Peter Stearns, who is Director of the FSLIC is testifying tomorrow, and he has a better handle on the operating numbers than I do. My guess would be in the range of $2 billion or so.

Mr. **Schumer**. How many institutions was that?

Mr. **Hemel**. I just don't know. On the order of, I presume, a dozen or two dozen.

Mr. **Schumer**. Let's assume it is 50 institutions. You said a dozen or two dozen——

Mr. **Hemel**. It hasn't been 50.

Mr. **Schumer**. I understand that. I am making an argument for you. I am being unusually conservative, uncharacteristically so. I am just trying to figure out how much it costs you per institution, and how many institutions will go under before you run out of money. And it seems to me it is not very many.

Let's say the cost is $2 billion. Let's say 25 institutions. We will have it your way, all right? So that means, if I can—you gentlemen are better at arithmetic than me. That is why I am a Congressman—that would mean it would cost you about $80 million per institution. Am I right on that?

Even if it doesn't cost you $2 billion, my point, Mr. Hemel, is don't you think the funds—that the FSLIC ought to be lobbying to get more money?

We don't want to get close to the bottom of the barrel since we all know confidence is so important in the banking system.

Mr. **Hemel**. Well, in terms of getting more money, we did impose a surcharge, as you know, every quarter of this calendar year which basically doubled our annual revenues. That was quite a controversial move in the thrift industry, not surprisingly, since they have to pay the bill. We are certainly cognizant of the need for that surcharge. So I don't think there is any disagreement with us.

Mr. **Schumer**. Do you think the surcharge is adequate?

Mr. **Hemel**. Again, depending on the variables at that time, yes.

Mr. **Barnard**. Would you yield?

Mr. **Schumer**. Yes.

Mr. **Barnard**. Mr. Schumer, I was wondering what is the position of the Federal Home Loan Bank Board on the 1-percent setaside was successful as far as the credit union insurance fund was concerned?

Mr. **Hemel**. We don't oppose it, Congressman. It originally hit the papers because a major trade association was considering recommending it. We certainly don't oppose it, obviously.

Mr. **Schumer**. Would you recommend it to Congress?

Mr. **Hemel**. You understand Board Members have not taken an official position on that so I can't answer that question.

I should add the revenues that would have been achieved by that recapitalization plan are very similar to the revenues now achieved by our 12½ basis points surcharge.

Mr. **Schumer**. I think you can bring back the message to your board that at least this member of the committee, and I dare say many others, feel you ought to be considering the proposal Mr. Barnard mentioned. You also ought to be considering other ways to beef up your reserves because I for one am worried about them and certainly feel all we need in this country to give our thrift industry a telling blow is for somebody to start saying there is not enough in there, then you are going to see the same thing that happened elsewhere when people got worried. I know this is taboo and we shouldn't talk about it. But I have found not talking about these things make them worse.

Let me ask another question of you, Mr. Hemel, then I will ask it of others. How many new examiners have you added on? All the testimony says that you are supervising a changing industry. How many new examiners has the Federal Home Loan Bank Board added on in the last year?

Mr. HEMEL. I can't answer for the last year. Our goal is to double the number of examiners between sometime this year and by the end of 1986. We are going from about 800 to 1,500 by the end of 1986. We have faced personnel constraints imposed upon us by the Office of Management and Budget until very recently and so we were not able to expand as much as we might have liked to otherwise.

Mr. SCHUMER. They have lifted those constraints?

Mr. HEMEL. We have transferred those functions from essentially from the Civil Service to the Federal home loan banks, which aren't subject to the same limits.

Mr. SCHUMER. The same question for the other witnesses. The Comptroller.

Mr. PATRIARCA. Our total full-time equivalent positions for last year numbered 2,900. There were 2,850 the year before that, and we asked for 3,000 for next year.

Mr. SHUMWAY. Our numbers of examiners actually declined in the last—until about a year ago in line with the overall Government efforts to constrain numbers of Federal employees.

Mr. SCHUMER. Your former boss was busy deregulating everything and cutting back on the people who were supposed to monitor deregulation?

Mr. SHUMWAY. Something like that. But in any event, we have turned that around and we are now, we have increased our staffing levels. Our current level is around 2,000. We are below that. We hope to reach it fairly soon.

Mr. TAYLOR. We have approximately 1,000 examiners. That is up marginally over last year and we anticipate in the coming year to add to it significantly, somewhere on the order of 15 to 20 percent.

Mr. SCHUMER. Finally, I think except for Mr. Taylor, all of us ought to go back and think about whether you need some more examiners in this brave new world of banking we have.

I thank the chairman.

Chairman ST GERMAIN. I am going to interject a question that follows the line of questions Mr. Schumer has been asking.

Mr. Hemel, what is the average tenure of your examining staff? In other words, do they stay with you 1 year, 2 years, 3 years, or only 18 months?

Mr. HEMEL. We will have to get back to you with specific numbers. It is not as long as it should be.

Chairman ST GERMAIN. It is a short tenure, isn't it?

Mr. HEMEL. Yes.

[In response to the request of Chairman St Germain, the following information was submitted for the record:]

Turnover rate of FHLBB examination staff

Fiscal year:	*Rate (percent)*
1981	10.4
1982	10.2
1983	11.7
1984	16.1
1985 [1]	18.6

[1] Annualized rate for fiscal year through July 6, when staff was transferred to the Federal Home Loan Banks.

Chairman **St Germain**. It is a good step toward employment in a financial institution, to be an examiner?

Mr. **Hemel**. Yes sir.

Chairman **St Germain**. Frankly, it makes a lot of sense. So there has to be a problem of remuneration?

Mr. **Hemel**. Yes sir.

Chairman **St Germain**. Mr. Patriarca?

Mr. **Patriarca**. Mr. Chairman, Mr. Downey just whispered to me that our average tenure is on the order of 8.3 years. In the last several years we have hired several hundred brandnew people. Our problem is not so much numbers as retaining——

Chairman **St Germain**. I recall the Bank of Boston hearing and the tenure, the fact they we had problems because a lot of people were no longer with them and that they had some very new examiners.

Mr. **Patriarca**. Our turnover rate is something on the order of 15 to 18 percent annually.

Mr. **Shumway**. Our turnover rate traditionally has been fairly low, around 7 percent. But in the last year it also has increased and is about 15 percent.

Chairman **St Germain**. Mr. Taylor.

Mr. **Taylor**. Mr. Chairman, our turnover rate is approximately 12 to 14 percent. I would be happy to submit for the record the precise level.

Of our thousand examiners, we have approximately a core of 150 to 200 we view as very experienced people. With the balance of the force, we have the same problems as the other agencies and it seems to be the 3 to 5 year level that we lose a lot of people. One of the things we have tried to do to stem this problem is bring back some of our people who get out in the banking world and find out it is not everything they thought it was and their ambitions and objectives in life are different. We have been successful in bringing some of those back.

Chairman **St Germain**. Mr. Wortley.

Thank you, Mr. Chairman.

Let me pursue this with you. Most of the people who leave you leave you for economic purposes, or is it a greater challenge or job titles, or what? Start with Mr. Taylor.

Mr. **Taylor**. A variety of factors. I think that having watched and looked at and been trained in banking, one has the temptation to try to go be a banker. I also think a very critical factor is that we make examiners travel quite a bit, which doesn't provide for the ideal life, especially as one starts to develop a family and roots.

Mr. **Wortley**. Mr. Shumway.

Mr. **Shumway**. Very same thing for us. I really can't add to it.

Mr. **Wortley**. Rather than go through everyone down the line, does anybody have another element that enters into it?

Mr. **Patriarca**. It seems that our turnover rate is in a sense tied to the problems in the industry. When the industry starts to perceive that there are asset problems, they turn to us, and I am sure the other regulators as well, as a very fertile source of talent with regard to controls and asset quality concerns that our examiners can provide. I have mixed feelings about it. I hate to lose examiners, but at least they are going to correct the problems in the banks.

Mr. **Wortley**. Who are they correcting?

Mr. **Patriarca**. Some do.

Mr. **Wortley**. We hope so. Anybody else have anything to add to that?

Let me go to Mr. Patriarca again. You suggest Congress faciliate bank adaptation to changes in the marketplace by relaxing the product and geographic restrictions in commercial banks. Specifically, what product lines would you have opened up to the banking system and how would such additional lines of financial services affect the tasks and responsibilities of traditional banking regulators.

Mr. **Patriarca**. Congressman, we have undoubtedly inundated you and this subcommittee and other committees of the Congress with testimony on that subject over the last several years. Mr. Conover must have delivered that message so many times that he could deliver it in his sleep, touting a series of product expansions in securities, real estate development, and the like.

I don't know that it matters so much exactly what menu of new product lines the Congress comes up with. From our standpoint, from a safety and soundness standpoint, we think that if you diversify the income streams, you diversify the risk, and that would be a good thing at the moment.

Mr. **Wortley**. Isn't that going to affect the responsibilities though of your traditional banking, traditional bank regulators?

Mr. **Patriarca**. No question about it.

I think that any time you expand the list of opportunities for bankers, you expand the list of opportunities for them to screw up. But, quite frankly, the ones who are likely to screw up are doing quite a good job of it now with a limited range of activities.

There is no question as to whether our responsibilities will increase as the lines of business increase for the banks. While we support new lines of business, we are not going to suggest that deregulation means that the regulators do not continue to pay attention to what the banks are doing.

Mr. **Wortley**. Are the regulators starting to take into consideration the possibility of the expansion of product lines and are you revving up the machinery to cope with that?

Mr. **Patriarca**. Quite frankly——

Mr. **Wortley**. What sort of planning?

Mr. **Patriarca**. Even without legislation, we are seeing expansion of product lines. The banks have been shooting through loopholes for more than a few years now. I do not think that is the best way of deciding what a bank should do. That decision should be made on the basis of what is the best business as opposed to how a loophole can be squeezed through.

The demands on us have increased immeasurably, not only by virtue of the traditional kinds of problems that the banks are facing with agriculture and energy loans and that sort of thing, but by virtue of the fact that the banks are doing new and wild and wonderful things that they have never done before. Their new off-balance sheet activities have got us scrambling to get a handle on exactly what the numbers are, what the risks associated with them are, and what controls banks should have in place to deal with them.

Mr. **Wortley**. Do you think your regulators are up to speed with coping with that right now?

Mr. **Patriarca**. The simple answer is no, that things are moving too fast given the resources we currently have available.

Mr. **Wortley**. What are you starting to do about it?

Mr. **Patriarca**. Believe me, we are starting to do something about it. I think the risk based capital effort is the most tangible thing I can cite in terms of trying to associate the risk with the price of taking that risk.

Mr. **Wortley**. Thank you.

Chairman **St Germain**. Mr. Vento.

Mr. **Vento**. Thank you, Mr. Chairman.

I am a little confused at some of the testimony, Mr. Chairman, but we have some charts before us, maybe if I could put some figures to the chart it would be helpful, by questions to the FDIC, FSLIC and National Credit Union Administration.

What is right now the deposits for classified troubled institution for the FDIC and the value of your fund, Mr. Shumway?

Mr. **Shumway**. Well, the deposits of our all insured bank problem institutions——

Mr. **Vento**. I don't want any double accounting. I am going to be asking the same question.

Mr. **Shumway**. As of the end of 1984, the total asets were $186 billion. I don't have the number.

Mr. **Vento**. Is that the insured amount?

Mr. **Shumway**. No, that is just total assets.

Mr. **Vento**. That isn't what I asked. You don't have the insured amount, is that what you said?

Mr. **Shumway**. I don't have it with me.

Mr. **Vento**. You don't have the insured amount with you? In other words, if I were going to be an actuary and going to ask what is the exposure of my liability, you couldn't answer that question right now?

Mr. **Shumway**. No, but on the other hand, when a bank fails our loss does not necessarily correlate to the insured liability.

Mr. **Vento**. I understand that. I understand it very well.

You can't answer my question?

Mr. **Shumway**. Right.

Mr. **Vento**. Mr. Hemel.

Mr. **Hemel**. In our questions and answers that we prepared along with our testimony, I said that problem cases "have $2.9 billion in assets and $198 million in deposits."

Mr. **Vento**. What is the value of your fund?

Mr. **Hemel**. The balance of the fund is close to $6 billion.

Mr. **Vento**. $6 billion versus $198 million exposure, and the credit unions?

Mr. **Riley**. Problem institutions, we have $3.8 billion. We have 96 billion dollars' worth of insured shares and the insurance fund is $1.2 billion.

Mr. **Vento**. What is the total aggregate figures you are giving me for total deposits?

Mr. **Riley**. Assets?

Mr. **Vento**. Deposits. The liability, the supposed liability?

Mr. **Riley**. $3.8 billion.

Mr. **Vento**. Now, the question is that of course you don't use that, you use other vehicles like mergers and other means at your disposal to address that, but nevertheless, I think it is important, at some point, that we get a picture of what has been happening to that over the years. Mr. Shumway, FDIC, of course, has asked us repeatedly, or suggested that they are making proposals to try and rate risk with regard to risk based insurance. That may be an oversimplication. Nevertheless, that is what they have sought. Do you have a basis today to present to us, have you presented a basis to date with regard to rating the quality of various instruments or investments so that we know what the basis of that risk based insurance might be?

Mr. **Shumway**. I don't have the details of our risk based premium proposal, but my understanding is that Chairman Isaac will provide this informatioin when he testifies before this subcommittee in a week or so.

Mr. **Vento**. I think that, Mr. Chairman, I just think it would be useful for us to know what the intention is prior to the passage of that or action on it rather than after the fact, so we know what the basis is that we are doing it, because this is obviously a key issue for the members and for what the impact might be on that policy.

Mr. Chairman, I yield back the balance of my time.

Chairman **St Germain**. Mr. Taylor, the Federal Reserve reported to the subcommittee that as of year-end 1984, there were 173 problem bank holding companies, with assets of $72 billion. In your testimony, on the bottom of page 8, you report that as of June 30 the number of problem bank holding companies has risen by 151 with total assets reaching $158 billion. That is more than double, as far as the assets are concerned.

Now, that is rather, it seems—maybe I am wrong—rather significant for such a short period of time. Would you explain the increase? Should we anticipate that increase to continue, or this trend to continue? Last are these holding companies listed as problems mainly because of banking or nonbanking activities?

Mr. **Taylor**. Mr. Chairman, if I could answer the last question first, the bulk of the holding companies are on there for banking problems as opposed to nonbanking problems. That is not to say there aren't some nonbanking problems.

As it relates to the increase, yes, it has increased rather dramatically, and we think that at this point it may increase further. I think most of the increase will likely be in the number, as we anticipate the smaller problem holding companies to grow as opposed to the large ones, although I wouldn't be surprised to see some increase in both.

Chairman St Germain. Mr. Patriarca and Mr. Taylor, in the responses of your agencies to this subcommittee, it was problem loans at national banks over $1 billion in assets that amounted to 3.22 percent at year end 1984, whereas the level of Federal Reserve member banks over $1 billion was 24 percent. Is that an accurate difference, and if so, how do we explain it?

Mr. Taylor. The data that is provided I believe is based on our shared national credit program and therefore it is limited in its scope.

I believe that the answer probably lies in the location and the particular chartering preferences as it relates to the energy problem fundamentally, that is. most large banks in Texas and Oklahoma are national banks.

Mr. Patriarca. That is my best guess as to the reason, too.

Chairman St Germain. Is there a reason for them being national banks? In other words, let's go one step further.

Mr. Patriarca. They want the best quality supervision available.

Chairman St Germain. Mr. Taylor?

Mr. Taylor. We are pleased that they are also members of the Federal Reserve System.

Chairman St Germain. Mr. Riley, one of the things we have noticed over the years is that when we see very rapid growth we also get apprehensive about the problems that may occur. Now, you reported to us that credit union assets are growing at 30 percent a year. Most credit unions appear to be improving nicely, according to your report, but the rapid growth certainly still is, I think, a matter of concern.

Is the NCUA monitoring this closely to make certain that this rapid growth does not, as we have seen occur in many institutions where there is rapid growth.

Mr. Riley. We have put out a supervisory alert to credit unions advising them about particularly the rapid growth in shares and where they are placing their money, whether investment or lending. We have also done a data screen as of June 30 to pick out those credit unions which are showing abnormal growth and we are having an examiner contact each of those credit unions because that has been the area where we have experienced our greatest loss in the last couple of years. They will have an individual examiner contact prior to probably the end of this month.

Chairman St Germain. Do you have sufficient examiners to perform this task for you, experienced examiners?

Mr. Riley. We, like other agencies, are getting very low on experienced examiners. I would say 75 percent of our examiners have less than 3 years senority and it really takes a good 3 to 5 years to get a good examiner trained, so we are recruiting heavily right now.

Chairman St Germain. Now, in response to a question on that net income as a percent of equity capital, the Federal Home Loan

Bank Board produced a chart showing an aggregate return on equity figures for 1982 minus 10.48 percent. The figure for 1983 is plus 13.28 percent; 1984 is plus 23.717 percent. Could either Mr. Hemel or Mr. Passarelli explain the reasons for these dramatic swings?

Mr. **Hemel.** Sure, Mr. Chairman. Earnings have swung dramatically in recent years. In 1982, the industry lost money. It had a negative return on equity; 1983 was a relatively good year; 1984 wasn't as good; 1985 should show another swing upward.

Chairman **St Germain.** Mr. Taylor and Mr. Patriarca, in the statistical information that your people provided to us, I note that from 1982 to 1984 there has been a steady increase in the percentage of nonperforming foreign office loans, expressed as a percentage of equity and loan loss reserves. Can you explain the increase and does this mean that State member banks with foreign offices and national banks with foreign offices, are continuing to make foreign loans that are becoming increasingly nonperforming or past due? And are these bad foreign loans?

Mr. **Patriarca.** With regard to nonperforming loan levels, in 1984 there was a clarification of our longstanding practices with regard to when loans must be reported as nonaccrual. There were a number of banks with significant exposure to foreign loans which after the clarification reported significantly higher foreign performing numbers. That is the principal reason that the numbers jumped in 1984.

Mr. **Taylor.** I would agree with that and I would go on and answer your question as it relates to the continuing lending. We don't notice a rapid or even a moderate increase in new foreign lending. I think most of it represents advances trying to work out specific credits.

Chairman **St Germain.** So would the lending trend be flat or actually on the decrease, other than the advances, to work out present loans?

Mr. **Taylor.** I think we would have to segment it by location in the world, but I think it would be more flat than down.

Chairman **St Germain.** Again, I request the OCC—I asked for figures on classified energy loans and note that the OCC figures indicated that classified energy loans expressed as a percentage of equity for national banks increased significantly from 0.59 percent in 1982 to 2.73 in 1983 and 2.13 in 1984. A twofold question, Mr. Patriarca.

First, what was the cause of this increase for national banks? You may go back to the previous answer you had for us. Also, how long does it take for a bad energy loan to show up on a national bank's books and for the OCC to get notice of the bad loan to show up on examination reports and subsequently in statistics on classified energy loans that you present to this committee? In other words, give us an example of a bad energy loan, and an energy loan that goes bad, and the timeframe between that energy loan being nonperforming, so to speak, and the timeframe for getting it on your statistical sheet?

Mr. **Patriarca.** Mr. Chairman, I think that the answer to your two questions is the same, that is, in late 1981 the bottom fell out of the oil market, and the prices started to decline. There was automatically a glut. Thanks to the simultaneous impact, that had on the whole energy business, we have had a series of problems among energy borrowers. The effect depended, in my view, on the strength of the borrower to start with. Some were on the margin; some had little capital and were operating on a shoestring. Their loans almost immediately were classified as doubtful or loss. As conditions have continued to deteriorate, the operating positions of energy borrowers continue to erode. Although some were hanging on in earlier times by virtue of their capital position and other things, they are slowly falling off the edge of the Earth.

Chairman St Germain. Let's say for the purpose of getting an answer here on the timeframe, let's say that an energy loan goes bad. It begins to be nonperforming today. How long does it take—how many months does it take before that loan, if it persists in a nonperforming status to show up on your statistical sheet?

Mr. Patriarca. It would show up at the next examination of the bank. In addition, the bank has to report it as a nonperforming loan on the next quarterly call report. Assuming that the bank does so, we are talking about 90 days. If the bank fails to do so, they have a real problem with us, and at the next examination we are going to express that problem to them in no uncertain terms.

Chairman St Germain. So it could be for a period as long as 90 days? It would appear on your statistical sheet at what outside period?

Mr. Patriarca. Mr. Chairman, it would probably go no longer than our next examination of the bank. The next examination will depend on the condition——

Chairman St Germain. The bank's next examination appears 8 months from now. The expert goes in and he finds that, and he writes it on his statistical sheet.

Mr. Patriarca. It goes on our statistical sheet. It goes into the next call report. If there are a number of loans that bank has not properly classified, we will require the bank to refile its call reports from the previous periods when they were not accurately reflected.

Chairman St Germain. Now, Mr. Patriarca, we also asked for nonperforming agricultural loans expressed as percentage of equity. That was dramatically increased in 1983 to 1984 in small banks with assets between 1 and 300 million, from 3.1 to 85 percent. In addition, there is a footnote in the chart that says, "In 1984 only banks with agricultural loans greater than 5 percent or domestic loans reported this data versus 1 percent for 1982 and 1983."

Does this mean that even though the 1984 statistics show a dramatic increase, the increase might even be greater?

Mr. Patriarca. Mr. Chairman.

Chairman St Germain. Do you want Mr. Downey to answer that?

Mr. Patriarca. With your permission, I will ask Mr. Fiechter to answer that.

Mr. Fiechter. I would agree with the thrust of what you are suggesting, that by raising the threshold to 5 percent we would be missing those banks that had relatively few agricultural loans. I am not certain whether we can provide for the record why that change was made.

Chairman St Germain. Do you know who made the changes?

Mr. Fiechter. I believe it might have been the FFIEC I do not know.

Chairman St Germain. Could you determine that, and then have that reported back to me?

Mr. Fiechter. Yes, sir.

Chairman St Germain. Not only who may have made the decision, but second, on what basis, or for what reason, was that change made?

Mr. Fiechter. Yes.

Mr. Patriarca. I can only tell you that there was no attempt to conceal the problems. There are problems here and they are real.

[In response to the information requested by Chairman St Germain, the following was submitted for the record by Mr. Fiechter:]

The decision to raise the reporting threshold was made by the Reports Task Force of the FFIEC. Because it was adding new reporting requirements to the 1984 call report, the Task Force attempted to alleviate the overall reporting burden on financial institutions by raising this threshold, as well as making other similar changes.

Chairman St Germain. Now, Mr. Passarelli, in response to the questions of the Federal Home Loan Bank Board, you provided statistics showing a number of problem organizations by years, since 1980 as well as number of failed institutions since 1981. I note the total number of problem organizations has increased from a total of 159 in 1980 to a total of 1,024 in 1984.

Has the total number of failed organizations during this time actually decreased from a total high in 1982 of 248 to a total of 94 in 1983, and 54 in 1984? Would you explain the situation to us?

Mr. Hemel. One of the problems, quite honestly, is the way we keep statistics. I think for the record we are going to have to clarify that. It just came to my attention yesterday that an institution like Beverly Hills where essentially—the institution failed, and reorganization occurred, was not showing up on FSLIC records as failures in the sense that the institution did not disappear. I think, obviously that was a failure, and we need to update that chart in accordance with that data collection problem.

Chairman St Germain. Are you telling us that that will be done, and we will have it submitted to the committee for its records?

Mr. Hemel. Yes, sir.

Chairman St Germain. In the question about your fund broker deposit processed as a percentge of total deposits, the Federal Home Loan Bank Board presents its statistics as showing steady quarterly increases from 1980 to 1984 in broker deposits. What impact have these increases had on the condition of the industry today, Mr. Passarelli? Can you comment on these increases—or Mr. Hemel, either one?

Mr. Hemel. The question, Mr. Chairman, is to what extent has the growth in jumbo deposits and——

Chairman St Germain. Jumbo and broker deposits and other borrowings, what impact have these increases had on the condition of the S&L industry today?

Mr. Hemel. It is impossible to decouple growth in those areas, with growth generally, by and large, institutions who plan to pursue a very rapid growth strategy could use those as funding conduits. It is much harder to grow rapidly by extending a retail base because you only have so many branches, so many tellers.

Sure you can expand that, but it takes time. If you want to do it fast, brokered deposits and jumbos have been the way to go, and as I indicated in my testimony, rapid growth, which is correlated with those things, is the cause of a very, very large proportion of our current problem.

Chairman St Germain. The answer is they have had—when utilized to achieve rapid growth—an adverse effect on the industry, yes. Mr. Carper.

Mr. Carper. Thank you, Mr. Chairman. I just want to say this has been a most illuminating hearing today, and to express my appreciation to you for holding it, and to the witnesses for appearing.

I would first like to get a couple of points clarified. I have heard some of the witnesses refer to risk-based capital requirements. I am not certain as to whether those requirements can be imposed with or without legislative mandate. Can someone clear that up?

My impression is that you need nothing from the Congress in order to be able to impose risk-based capital requirements. Is that right?

Mr. Patriarca. That is correct.

Mr. Carper. At a meeting yesterday with some of our bankers from Delaware, one of them said something to the effect that—talking about examiners and hiring people for their own banking staff. I think the comment from our Delaware Bank was why train them when you can hire them trained.

I think what he was talking about was going out and hiring people that work for either the Federal Reserve or Comptroller or FSLIC or Federal Home Loan Bank Board. I have heard a lot of comments today about the quality of the training, the quality of examiners that were being able to hire. I thought those comments were very helpful for me.

I have also heard some concerns expressed about the ability to remove bad managers, heard some discussion here about brokered deposits, and the risk they face; heard some people say we need risk-based premiums. What I would like to do is focus on a question and to ask each of you to tell me which is most critical.

This is a wish list. If you get one thing off of this wish list, that being flexibility to hire examiners and pay them better, treat them better, if you had the ability to do that, that is one wish. The second wish is the ability to remove bad management, more flexibility to remove bad managers. A third wish is to be able to do something to limit brokered deposits. And finally, the fourth wish is the assessment of risk-based premiums.

Of those four, which would be your first choice. I would like to start with Mr. Taylor.

Mr. Taylor. I would point out here that we have a whole host of examiners who have done extremely well for us over the years, and we are quite proud of them. But I think my wish would be to have more people in the field fully qualified, with access to the best of training. We are trying to address those concerns.

As it relates to risk, I think then it would follow that we would want the flexibility to deal with the problems we see, and I think it doesn't lie at the removal of managers more freely. I am not so enamored over risk-based deposit insurance, but I don't mean to speak for the agency specifically. I think the risk-based capital standards will help us greatly in separating those who are taking the risk and thereby creating the difficulty.

Mr. **Carper**. Thank you.

Mr. **Taylor**. I might add that in saying those are wishes, those are also responsiblities.

Mr. **Carper**. All right, Mr. Shumway, could you sort of put those in some priority for me?

Mr. **Shumway**. Well, I find it hard to differentiate. They are all very important. But I regard brokered deposits as a very, very serious problem and a threat to the insurance system, and I would have to place that at the top.

Mr. **Carper**. What would you put at the bottom of those four?

Mr. **Shumway**. Probably risk-based premiums. I think it is the fair thing to do. I think it is imporant, but I don't see it as a panacea.

Mr. **Carper**. All right.

Mr. **Patriarca**. I would agree with Mr. Taylor that in light of the complexities the regulators are facing today, and are likely to continue to face, we have got to be able to retain highly trained people. That is, bar none, my first wish. No question about it.

Mr. **Carper**. What would be the least important?

Mr. **Patriarca**. Least important is brokered deposits. I have a great deal of respect for Mr. Shumway, but I think he missed the mark on this. I don't think they are a big deal in practice.

My second wish is that the standards for removal of management be loosened. Right now, you have to be able to prove that there is a willful disregard for the safety and soundness of the bank. That is a pretty tough standard. Incompetence does not equate to that.

Mr. **Hemel**. Really speaking for myself, I would have to agree with Mr. Taylor and Mr. Patriarca. You can't implement a risk base premium or capital system or be effective in launching a winning cease and desist proceeding unless you have effective people. You need that first. Everything else without that is theoretical. So that is what we need first.

As far as lease, I really don't have an opinion.

Mr. **Carper**. Finally, Mr. Riley.

Mr. **Riley**. I think first on our list is the flexibility to hire, recruit, and pay our examiners. The agency is opposed to risk-based premiums on the other two items, management removal and broker deposits, we feel comfortable with what we have.

I would like to say, though, on conservatorship authority, which is sometime tied into management. That does expire for us on October 15. We would like to see that extended.

Mr. **Carper**. Thank you all very much.

Chairman **St Germain**. Mr. Barnard?

Mr. **Barnard**. Mr. Chairman, I would like to follow up very quickly on a question that you asked Mr. Patriarca as to the time element between a loan becoming bad and the time that it would show up on your records, in particular energy loans.

Energy loans have been, according to my understanding, somewhat speculative. In other words, I know that the banks in those areas make energy loans for the drilling and for exploration of oil and gas. Before 1981, they used to be very careful about the margin of the loan, how much loan they would make.

In other words, they would not nearly be as speculative about it. Then as it became apparent—I am trying to see if I am right—as it became apparent that we were going to have an energy shortage, and we got into this big interest of more drilling and more wells and more energy capacity, didn't we see a trend developing that the regulators should have sensed that we were becoming more and more speculative in that development, and as a result we may have abdicated some good banking principles during that period of time?

Do we get a feedback from the field from your examiners that these trends are changing, where it would become noticed by the regulators, and they would get out a proposal or at least a notification, be cautious about this trend?

This trend is against all of the past practices that we have condoned, and for that reason be cautious about it rather than say we are in the midst of a great thing. But it looks like to me this is a combination of failures on the part of bankers, but also on the part of the regulatory agencies to sense that we were being a lot more loose in the handling of energy loans than we had previously.

Now, that also relates to the farming situation. We have known, I know, of those in Congress have known for many, many years that we were not moving toward a better situation as far as the farming was concerned. So there again, is there an effort by the regulators to communicate back to the field to say, OK, let's put some further emphasis on this particular problem?

Mr. PATRIARCA. Speaking on behalf of the Comptroller's Office, the answer to your question is yes. My sense is that you are right in your rendition of the energy shortage. It was the go-go era, the price of oil was going through the overhead, and everyone predicted that we would have at least 5 percent annual growth in the price of oil to at least $60 a barrel. And all of a sudden, the lending policies of the energy banks became relaxed. That turned out to be a recipe for disaster, and we had a disaster.

Now, thanks to our industry review program, we are communicating to our examiners trends in the various economic sectors. We are trying to raise flags before the fact, before the price of whatever commodity it is falls through the floor.

Mr. BARNARD. In other words, you feel like you are communicating back the banks should be requiring more margins in their lending practice.

Mr. PATRIARCA. We are communicating to examiners the need to scrutinize the lending policies of the banks closely and when there is a deviation from what has traditionally been a standard of prudence to question it and find out if there is any basis for it.

Mr. BARNARD. Was that done during the late 1960's, though?

Mr. PATRIARCA. I think it probably was done in areas like real estate. It probably was not done in oil.

Mr. BARNARD. Other gentlemen have any response to that? Do you agree or disagree?

Mr. **Taylor**. I tend to generally agree. I guess it is the margin. It is also the basis for the computation of the repayment. You get paid from an income stream or get paid from the resale of collateral. I think what happened in the last decade or so is that the borrowers and the bankers may have relied too much on the ability of the collateral to go up in value. Therefore, don't worry about the repayment from an income stream as ultimately you could sell the collateral to recapture the loan.

Mr. **Barnard**. In other words, instead of asking for this 3C's of credit, I ask you for only three: charger, capacity, and capital.

Mr. **Taylor**. I also believe in the fourth one, collateral.

Mr. **Barnard**. What about conditions?

Mr. **Taylor**. And conditions is fifth. It depends on what school of C's one went to. But, clearly, the income streams that were factored into the oil lending were inflationary, that the income stream projected was predicated on the price of oil going up, and therefore, the value of the collateral over time also going up. It was inappropriate.

Mr. **Barnard**. I think I have gotten over the meaning of what——

Chairman **St Germain**. Was it inappropriate, or it is inappropriate in retrospect, and erroneous?

Mr. **Taylor**. Aggressive and risk prone.

Chairman **St Germain**. Now, we see that it was inappropriate, but back when it was made it was an error in judgment, that is why so many made that same error.

Mr. **Taylor**. There was more often a tendency in those days to have a general assumption. I think the general populace felt that inflation would continue. That is not as prevalent a view today.

Chairman **St Germain**. And that the energy crisis would continue?

Mr. **Taylor**. Yes.

Chairman **St Germain**. Remember we were told we are running out of oil.

Mr. **Taylor**. Absolutely.

Chairman **St Germain**. That is why we wanted the Congress to adopt the synfuel programs. We were going to convert coal to oil because the price of oil was going up so high. We were going to do it on an economic scale.

Mr. **Taylor**. I can't imagine the audience that an examiner in 1977 would have gathered had he been able to perceive that oil would be at the price it is today.

Chairman **St Germain**. Gentlemen, we want to thank you.

Mr. **Barnard**. One more question: I would like to enlarge on this, but certainly time does not permit.

Mr. Hemel, there is a procedure whereby the FSLIC guarantees loans made by the various Home Loan Bank Boards.

Mr. **Hemel**. Yes, sir.

Mr. **Barnard**. According to the information I have got, in 1983, the FSLIC financial statement stated—actually in footnote 8, FSLIC considered the likelihood of ever incurring losses under these arrangements to be very remote. Yet at the end of 1983, the loan guarantees of which you were going to have to respond, as I understand it, amounted to $558 million.

In 1984, the FSLIC had to honor about $643 million of these guarantees and exercise claim to assets securing these loans.

My question is this: How much contingent liability does FSLIC have to these Home Loan Bank Boards now under this present plan? Is it continuing to increase?

Mr. **Hemel**. Let me say a few things. One is that by and large the loans are generously collateralized. We will get you back specific information for the record. The Director of the FSLIC is testifying tomorrow, and he is much more familiar with these matters.

Mr. **Barnard**. I may not be here tomorrow.

[In response to the request of Congressman Barnard the following information was submitted for the record by Mr. Hemel:]

FSLIC's contingent liability as guarantor for Federal Home Loan Bank advances has continued to increase. As of August 31, 1985, FSLIC was the guarantor of Bank advances totaling $2,490,570,000, with commitments to guarantee another $2,047,430,000 if needed.

Mr. **Barnard**. Let me ask you this: The guarantees from the FSLIC to the Home Loan Bank Board, they are not collateralized in addition, are they?

Mr. **Hemel**. No.

Mr. **Barnard**. Because I thought the program was based upon the fact that these S&L's did not have collateral to pledge.

Mr. **Hemel**. No; they do have collateral. The trouble is institutions do have collateral that is pledged from the banks. The FSLIC provides one more back up in case that collateral should ever prove insufficient.

Mr. **Barnard**. Do you perceive that this arrangement will continue to grow?

Mr. **Hemel**. I am just not in a position to say. I am sorry.

Mr. **Barnard**. All right, I will ask that to Mr.—what is his name?

Mr. **Hemel**. Mr. Stearns.

Mr. **Barnard** [continuing]. Tomorrow. Well, let me ask you this: How do you look on the fact that the Home Loan Bank Board of Chicago has referred to enter into a guarantee agreement to help a savings and loan in Chicago.

Mr. **Hemel**. I am just not familiar with that particular transaction other than what I have read in the newspaper, which you have read, too. I don't know the details of that.

Mr. **Barnard**. Would you speculate that this signals a serious disagreement in the overall systems as to how to proceed in some failing institutions?

Mr. **Hemel**. Again, I can't say. There seems to be disagreements at the local board on that particular problem. I don't think——

Mr. **Barnard**. You feel like Mr. Stearns would be more adequately able to answer that tomorrow?

Mr. **Hemel**. I think so.

Mr. **Barnard**. Thank you, Mr. Chairman.

Chairman **St Germain**. Thank you, Mr. Barnard, and gentlemen. We probably will have some additional written questions for you. We want to thank you for your assistance, and your cooperation, and your forthrightness, because all of this, as you know, is most important. The subject matter of these hearings, as we said earlier, is probably one of the most delicate, yet most important, we have had in many days in this hearing room.

The subcommittee stands adjourned.

[Whereupon, at 1:25 p.m., the hearing was adjourned, subject to the call of the Chair.]

[Letters of invitation to the witnesses for this day; a letter from Chairman St Germain dated August 1, 1985, sent to Chairman Paul A. Volcker requesting data regarding the depository institutions and holding companies under their jurisdiction. The letter was also sent to the Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, National Credit Union Administration, and the Office of the Comptroller of the Currency. Responses received from the above are attached; and charts prepared by subcommittee staff entitled "Depository Institutions Statistical Information," follow:]

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TOBY ROTH, WISCONSIN

September 3, 1985

Mr. William Taylor, Director
Division of Supervision and Regulation
Board of Governors, Federal Reserve System
Washington, D.C. 20551

Dear Mr. Taylor:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the present system of federal deposit insurance, you are requested to appear before the Subcommittee on September 11, 1985, at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to testify on the financial condition of the depository institutions including holding companies under the jurisdiction of your agency.

In your testimony, please provide the Subcommittee with a thorough overview of current financial conditions and respond specifically to the questions below with respect to the smaller, intermediate, larger, and money-center institutions (including holding companies) under your agency's jurisdiction.

1. Are current levels of capital, including consideration of classified assets and off-balance sheet items, adequate? How do current capital levels compare with levels in previous years? Regarding money-center institutions specifically, have capital-to-asset ratios, including adjustments for classified assets and off-balance sheet items, been declining or increasing in recent years?

2. How sensitive is asset quality to national and international economic conditions? What is the current level of asset quality, and how has it been affected in recent decades by successive periods of recession and recovery? With regard to agricultural, international, energy, and real estate lending, what are present conditions, and how do they compare with those of recent years? With regard to letters of credit and other off-balance sheet items, what are the trends in the amounts of these items, and how are these trends explained?

3. What are the current levels of bank earnings with respect both to equity and to total assets, and how do these levels compare with those of years past?

4. How do current liquidity levels, particularly in the form of uninsured and short-term borrowed funds, compare with those of previous years? What has been the impact of the increased use of brokered deposits?

5. What is the present number of so-called "problem institutions"? What is the amount of total deposits held by these institutions? Why has the number of "problem institutions" changed as it has in recent years? Is the trend in the number of "problem institutions" due mainly to shifts in national and international economic conditions, to changes in the rigor of federal agency supervision, to changes in the risk preferences of institution managers, or to the operations and premium levels of the Federal Deposit Insurance Corporation? What supervisory actions are being taken in response to the trend in the number of "problem institutions"?

6. How many institutions have had to be liquidated, merged, or assisted to avert failure so far this year, and how does this number compare with those in previous years? Do you expect this trend to continue?

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B-303 Rayburn twenty-four hours in advance of your scheduled appearance before the Subcommittee. Your prepared statement will be included in its entirety in the hearing record and, if delivered as requested, your statement will be distributed to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members sufficient time for questioning, the oral presentation of your testimony must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:dDv

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COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

September 3, 1985

Mr. Robert Shumway, Director
Division of Bank Supervision
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Mr. Shumway:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the present system of federal deposit insurance, you are requested to appear before the Subcommittee on September 11, 1985, at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to testify on the financial condition of the depository institutions under the supervisory jurisdiction of your agency.

In your testimony, please provide the Subcommittee with a thorough overview of current financial conditions and respond specifically to the questions below with respect to the smaller, intermediate, larger, and money-center institutions under your agency's jurisdiction.

1. Are current levels of capital, including consideration of classified assets and off-balance sheet items, adequate? How do current capital levels compare with levels in previous years?

2. How sensitive is asset quality to national and international economic conditions? What is the current level of asset quality, and how has it been affected in recent decades by successive periods of recession and recovery? With regard to agricultural, international, energy, and real estate lending, what are present conditions, and how do they compare with those of recent years? With regard to letters of credit and other off-balance sheet items, what are the trends in the amounts of these items, and how are these trends explained?

3. What are the current levels of bank earnings with respect both to equity and to total assets, and how do these levels compare with those of years past?

4. How do current liquidity levels, particularly in the form of uninsured and short-term borrowed funds, compare with those of previous years? What has been the impact of the increased use of brokered deposits?

5. What is the present number of so-called "problem institutions"? What is the amount of total deposits held by these institutions? Why has the number of "problem institutions" changed as it has in recent years? Is the trend in the number of "problem institutions" due mainly to shifts in national and international economic conditions, to changes in the rigor of federal agency supervision, to changes in the risk preferences of institution managers, or to the operations and premium levels of the Federal Deposit Insurance Corporation? What supervisory actions are being taken in response to the trend in the number of "problem institutions"?

6. How many institutions have had to be liquidated, merged, or assisted to avert failure so far this year, and how does this number compare with those in previous years? Do you expect this trend to continue?

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B-303 Rayburn twenty-four hours in advance of your scheduled appearance before the Subcommittee. Your prepared statement will be included in its entirety in the hearing record and, if delivered as requested, your statement will be distributed to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members sufficient time for questioning, the oral presentation of your testimony must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

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WASHINGTON, DC 20515

[illegible]

September 3, 1985

Mr. Michael Patriarca
Deputy Comptroller of the Currency
Department of the Treasury
490 L'Enfant Plaza East, S.W.
Washington, D.C. 20219

Dear Mr. Patriarca:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the present system of federal deposit insurance, you are requested to appear before the Subcommittee on September 11, 1985, at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to testify on the financial condition of the depository institutions under the jurisdiction of your agency.

In your testimony, please provide the Subcommittee with a thorough overview of current financial conditions and respond specifically to the questions below with respect to the smaller, intermediate, larger, and money-center institutions under your agency's jurisdiction.

1. Are current levels of capital, including consideration of classified assets and off-balance sheet items, adequate? How do current capital levels compare with levels in previous years? Regarding money-center institutions specifically, have capital-to-asset ratios, including adjustments for classified assets and off-balance sheet items, been declining or increasing in recent years?

2. How sensitive is asset quality to national and international economic conditions? What is the current level of asset quality, and how has it been affected in recent decades by successive periods of recession and recovery? With regard to agricultural, international, energy, and real estate lending, what are present conditions, and how do they compare with those of recent years? With regard to letters of credit and other off-balance sheet items, what are the trends in the amounts of these items, and how are these trends explained?

3. What are the current levels of bank earnings with respect both to equity and to total assets, and how do these levels compare with those of years past?

4. How do current liquidity levels, particularly in the form of uninsured and short-term borrowed funds, compare with those of previous years? What has been the impact of the increased use of brokered deposits?

5. What is the present number of so-called "problem institutions"? What is the amount of total deposits held by these institutions? Why has the number of "problem institutions" changed as it has in recent years? Is the trend in the number of "problem institutions" due mainly to shifts in national and international economic conditions, to changes in the rigor of federal agency supervision, to changes in the risk preferences of institution managers, or to the operations and premium levels of the Federal Deposit Insurance Corporation? What supervisory actions are being taken in response to the trend in the number of "problem institutions"?

6. How many institutions have had to be liquidated, merged, or assisted to avert failure so far this year, and how does this number compare with those in previous years? Do you expect this trend to continue?

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B-303 Rayburn twenty-four hours in advance of your scheduled appearance before the Subcommittee. Your prepared statement will be included in its entirety in the hearing record and, if delivered as requested, your statement will be distributed to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members sufficient time for questioning, the oral presentation of your testimony must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

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NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

September 3, 1985

Mr. Frank Passarelli, Acting Director
Office of Examination and Supervision
Federal Home Loan Bank Board
1700 G Street, N.W.
Washington, D.C. 20552

Dear Mr. Passarelli:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the present system of federal deposit insurance, you are requested to appear before the Subcommittee on September 11, 1985, at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to testify on the financial condition of the depository institutions under the jurisdiction of your agency.

In your testimony, please provide the Subcommittee with a thorough overview of current financial conditions and respond specifically to the questions below with respect to the smaller, intermediate, and larger institutions under your agency's jurisdiction.

1. Are current levels of capital, including consideration of classified assets and off-balance sheet items, adequate? How do current capital levels compare with levels in previous years?

2. How sensitive is asset quality to national economic conditions? What is the current level of asset quality, and how has it been affected in recent decades by successive periods of recession and recovery? What are the present conditions in real estate lending, and how do they compare with those of recent years?

3. What are the current levels of institutions earnings with respect both to equity and to total assets, and how do these levels compare with those of years past?

4. How do current liquidity levels, particularly in the form of uninsured and short-term borrowed funds, compare with those of previous years? What has been the impact of the increased use of brokered deposits?

5. What is the present number of so-called "problem institutions"? What is the amount of total deposits held by these institutions? Why has the number of "problem institutions" changed as it has in recent years? What proportion of these of "problem institutions" are institutions that are burdened only by a maturity mismatch -- the so-called "spread cases"? What proportion of the "problem institutions" are those with asset quality problems only? Is the trend in the number of "problem institutions" due mainly to shifts in national econmic conditions, to changes in the rigor of federal agency supervision, to changes in the risk of preferences of institution managers, or to the operations and premium levels of the Federal Savings and Loan Insurance Corporations? What supervisory actions are being taken in response to the trend in the number of "problem institutions"?

6. How many institutions have had to be liquidated, merged, or assisted to avert failure so far this year, and how does this number compare with those in previous years? Do you expect this trend to continue?

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B-303 Rayburn twenty-four hours in advance of your scheduled appearance before the Subcommittee. Your prepared statement will be included in its entirety in the hearing record and, if delivered as requested, your statement will be distributed to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members sufficient time for questioning, the oral presentation of your testimony must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

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NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

September 3, 1985

Mr. D. Michael Riley, Director
Office of Programs
National Credit Union Administration
1776 G Street, N.W.
Washington, D.C. 20456

Dear Mr. Riley:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the present system of federal deposit insurance, you are requested to appear before the Subcommittee on September 11, 1985, at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to testify on the financial condition of the depository institutions under the jurisdiction of your agency.

In your testimony, please provide the Subcommittee with a thorough overview of current financial conditions and respond specifically to the questions below with respect to the institutions under your agency's jurisdiction.

1. Are current levels of capital, including consideration of classified assets adequate? How do current capital levels compare with levels in previous years?

2. How sensitive is asset quality to national economic conditions? What is the current level of asset quality, and how has it been affected in recent decades by successive periods of recession and recovery?

3. What are the current levels of institution earnings,and how do these levels compare with those of years past?

4. How do current liquidity levels, particularly in the form of uninsured and short-term borrowed funds, compare with those of previous years? What has been the impact of the increased use of brokered deposits?

5. What is the present number of so-called "problem institutions"? What is the amount of total share accounts held by these institutions? Why has the number of "problem institutions" changed as it has in recent years? Is the trend in the number of "problem institutions" due mainly to shifts in national economic conditions, to changes in the rigor of federal agency supervision, to changes in the risk preferences of institution managers, or to the operations and premium levels of the National Credit Union Administration Share Insurance Fund? What supervisory actions are being taken in response to the trend in the number of "problem institutions"?

6. How many institutions have had to be liquidated, merged, or assisted to avert failure so far this year, and how does this number compare with those in previous years? Do you expect this trend to continue?

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B-303 Rayburn twenty-four hours in advance of your scheduled appearance before the Subcommittee. Your prepared statement will be included in its entirety in the hearing record and, if delivered as requested, your statement will be distributed to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members sufficient time for questioning, the oral presentation of your testimony must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:dDv

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OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

August 1, 1985

Honorable Paul A. Volcker
Chairman, Board of Governors
Federal Reserve System
Washington, D.C. 20551

Dear Chairman Volcker:

To assist this Subcommittee in the conduct of its responsibilities, each of the federal agencies supervising depository institutions and holding companies, is requested to provide the Subcommittee on or before September 6, 1985, with the information specified below for those institutions for which each has primary supervisory responsibility.

It is requested that the specified information be provided in the form of annual statistics on as a consistent a basis as feasible from year-end 1980 through the most recent period available. To enhance the utility of the information provided, the agencies are further requested to arrange to have their responses be as uniform in presentation as possible. If definitions, coverage, etc. have changed significantly, please so indicate in each of the responses and identify the time periods when such changes occurred.

Please provide for each type of institution or holding company, in the aggregate with the data weighted by assets or deposits, and for appropriate large, medium and small size categories, the following:

1. Number and total assets of "problem" organizations;

2. Number and total assets of organizations failed or absorbed to avert failure;

3. Primary capital as a percentage of total assets;

4. Primary capital less classified assets (defined as the sum of: 1/2 substandard, 1/2 doubtful, plus all of loss assets), as a percentage of total assets;

5. Primary capital less classified assets (defined as above), as a percent of total assets including standby letters of credit and other off-balance sheet items;

6. Classified assets (defined as above) and nonperforming assets, as a percent of total assets;

7. Classified (defined as above) and nonperforming energy loans, agricultural loans, international loans, and real estate development loans and investments, each as percentage of primary capital;

8. Purchased funds and brokered deposits, each as a percent of total assets;

9. Net income as a percent of equity capital; and

10. Any other information that would augment the Subcommittee's understanding of the current status of the financial condition generally of depository organizations.

My staff is available to dicuss this request with you.

I look forward to and appreciate your cooperation in meeting the information needs of the Subcommittee.

Sincerely,

Fernand J. St Germain
Chairman

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

September 4, 1985

The Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions Supervision,
Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Chairman St Germain:

In response to your letter of August 1, a packet of tables is enclosed providing data on state member banks and bank holding companies. The tables are preceded by some brief comments regarding the submission. This information reflects the results of discussions held with members of your staff and representatives of the other federal agencies supervising depository institutions.

As discussed with members of your staff, the Federal Reserve does not have results of bank holding company inspections in a computerized data base with sufficient detail to answer questions 4, 5, and 6. Thus, we are presently compiling this information, and expect to submit our response to the Subcommittee in the near future.

I hope the enclosed material will assist the Subcommittee in its deliberations.

Sincerely,

Paul

Enclosures

Notes Regarding the Federal Reserve Board's Submission of Data

- The Federal Deposit Insurance Corporation will provide responses to questions 1 and 2, and on brokered deposits in question 8 for all insured commercial banks. The Office of the Comptroller of the Currency will provide data on loans classified due to transfer risk for all insured commercial banks in response to question 7. The Federal Reserve Board is providing data on classified energy loans and real estate loans for all insured commercial banks, also in response to question 7. In addition, the Federal Reserve Board is providing data on nonperforming loans and net charge-offs in the real estate, agricultural, and international areas in response to question 10.

- Data from bank Call Reports and bank holding company F.R. Y-9 Reports are not directly comparable with data from bank examination reports and bank holding company inspection reports. This is due to the intermittent nature of exam scheduling among banks and inspection scheduling among bank holding companies, whereas Call Reports and F.R. Y-9 Reports present data at a single particular date for all institutions. The source used for each response is noted at the bottom of each table.

* Information submitted by the Federal Reserve in response to question 7 is derived from the annual interagency program for review and classification of Shared National Credits (SNC). A SNC is defined as any loan or group of loans to a borrower aggregating $20 million or more, either outstanding or committed under a formal lending agreement and (a) shared at its inception by two or more banks; or (b) a portion of which is sold to one or more banks with the purchasing bank assuming its pro-rata share of the credit risk. The SNC data is our only automated source of loan classifications aggregated by sector.

Question 1

Table 1

Number and Total Assets (in Billions) of Bank Holding Companies Rated Composite 4 or 5[1]

As of Year-End	Asset Size Class: Less Than $300 Million	Asset Size Class: $300 Million-$1 Billion	Asset Size Class: Greater Than $1 Billion	All Bank Holding Companies	
	No.	No.	No.	No.	Total Assets
1984	158	8	7	173	$72
1983	121	6	4	131	21
1982	52	3	6	61	20
1981	23	3	7	33	48
1980	30	3	6	39	42
1979	27	6	7	40	31

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[1] Bank holding company ratings have been collected since 1979.

Source: Bank Holding Company Inspection Reports.

Question 3

Table 2

Equity and Loan Loss Reserves as a Percentage of Total Assets 1/

State Member Banks

As of Year-End	Asset Size Class Less Than $300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All State Member Banks
1984	8.73	7.76	5.70	6.15
1983	8.96	8.17	5.44	5.98
1982	8.73	7.33	5.05	5.57
1981	8.71	7.31	4.94	5.51
1980	8.70	7.78	4.75	5.37
1979	8.55	7.64	4.77	5.38
1978	8.31	7.76	4.94	5.55
1977	8.27	7.81	5.19	5.80
1976	8.35	8.16	5.29	6.01
1975	8.46	8.27	5.43	6.18
1974	8.45	8.32	5.18	5.96
1973	8.25	7.93	5.25	6.00
1972	8.10	7.90	5.70	6.42
1971	8.31	8.39	6.23	6.96
1970	8.63	8.71	6.67	7.38
Memo: Primary Capital 2/ to Total Assets				
1984	8.73	7.76	6.03	6.42
1983	8.96	8.18	5.52	6.05

1/ All figures are weighted averages.

2/ Reporting of data on primary capital began in 1983.

Source: Call Report.

Question 3

Table 3

Equity and Loan Loss Reserves as a Percentage of Total Assets[1/]

All Bank Holding Companies With Assets Above $100 Million

	Asset Size Class			
As of Year-End	$100 Million-$300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All BHCs With Assets Above $100 Million
1984	7.39	7.28	6.19	6.33
1983	7.27	7.26	5.98	6.13
1982	7.21	7.08	5.55	5.71
1981	6.99	6.99	5.29	5.45
1980	7.01	7.05	5.14	5.30
1979	6.75	7.02	5.06	5.22
1978	6.66	6.94	5.16	5.32
1977	7.05	7.31	5.32	5.54
1976	7.19	7.31	5.53	5.74
1975	7.05	7.13	5.42	5.65

[1/] All figures are weighted averages.

Source: Form F.R. Y-9.

Question 4

Table 4

Examination-Determined Primary Capital Before and After Adjustment for Classified Assets as a Percentage of Total Assets[1]

State Member Banks

As of Year-End	Asset Size Class							
	Less Than $300 Million		$300 Million - $1 Billion		Greater Than $1 Billion		All State Member Banks	
	Primary Capital to Assets	Adjusted Primary Capital to Assets	Primary Capital to Assets	Adjusted Primary Capital to Assets	Primary Capital to Assets	Adjusted Primary Capital to Assets	Primary Capital to Assets	Adjusted Primary Capital to Assets
1984	8.97	8.13	8.10	7.55	5.75	4.86	6.22	5.35
1983	8.08	8.09	8.03	7.50	5.38	4.51	5.91	5.07
1982	8.31	7.64	7.14	6.48	5.04	4.35	5.52	4.83
1981	8.41	7.90	7.72	6.96	4.16	3.69	4.80	4.32
1980	8.25	7.83	7.70	7.21	4.33	3.85	4.99	4.52
1979	8.09	7.74	7.57	7.14	4.25	3.70	4.90	4.39
1978	7.89	7.54	7.70	7.15	4.64	3.92	5.29	4.63
1977	7.91	7.50	7.40	6.67	4.74	3.72	5.41	4.50
1976	7.82	7.34	7.45	6.44	4.75	3.50	5.49	4.38
1975	7.83	7.28	7.54	6.68	4.54	3.07	5.34	4.07
1974	7.82	7.42	7.49	6.92	4.58	3.73	5.41	4.67
1973	7.63	7.31	6.99	6.57	4.80	4.32	5.55	5.11
1972	7.55	7.23	7.34	6.94	5.90	5.44	6.45	6.03
1971	8.04	7.65	8.32	8.02	7.35	6.54	7.66	7.03
1970	7.34	7.93	8.76	8.46	7.19	6.52	7.71	7.15

---

[1] Classified assets are defined as 20 percent of substandard assets plus 50 percent of doubtful assets plus 100 percent of loss assets. The most recent examination as of year-end was used. Due to the intermittent nature of exam scheduling among banks, these data do not cover uniform periods, and therefore may differ from capital figures derived from year-end Call Reports. All figures are weighted averages.

Source: Bank Examination Reports.

Question 5

Table 5

Primary Capital Less Classified Assets as a Percentage of Total Assets Plus Standby Letters of Credit[1/]

State Member Banks

As of Year-End	Asset Size Class Less Than $300 Million	 $300 Million-$1 Billion	 Greater Than $1 Billion	All State Member Banks
1984	8.08	7.44	4.54	5.04
1983	8.05	7.42	4.12	4.70
1982	7.60	6.39	4.09	4.58
1981	7.85	6.87	3.45	4.08
1980	7.60	7.10	3.60	4.27
1979	7.71	7.05	3.50	4.19
1978	7.51	7.09	3.74	4.45
1977	7.47	6.61	3.56	4.34
1976	7.32	6.35	3.37	4.24
1975	7.26	6.58	2.95	3.94
1974	7.40	6.84	3.58	4.52
1973	7.31	6.57	4.32	5.11
1972	7.23	6.94	5.44	6.03
1971	7.65	8.02	6.54	7.03
1970	7.93	8.46	6.52	7.15

[1/] Classified assets are defined as 20 percent of substandard assets plus 50 percent of doubtful assets plus 100 percent of loss assets. The most recent examination as of year-end was used. All figures are weighted averages.

Source: Bank Examination Reports.

Question 6

Table 6

Classified Assets as a Percentage of Total Assets

State Member Banks

As of Year-End	Asset Size Class Less Than $300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All State Member Banks
1984	0.84	0.55	0.89	0.87
1983	0.79	0.53	0.87	0.84
1982	0.67	0.66	0.69	0.69
1981	0.51	0.47	0.48	0.48
1980	0.40	0.50	0.48	0.47
1979	0.34	0.43	0.54	0.51
1978	0.35	0.55	0.72	0.66
1977	0.41	0.73	1.02	0.91
1976	0.47	1.00	1.25	1.11
1975	0.54	0.86	1.47	1.27
1974	0.39	0.57	0.85	0.75
1973	0.32	0.42	0.48	0.44
1972	0.32	0.39	0.46	0.42
1971	0.39	0.31	0.80	0.63
1970	0.41	0.30	0.68	0.55

1/ Classified assets are defined as 20 percent of substandard assets plus 50 percent of doubtful assets plus 100 percent of loss assets. The most recent examination as of year-end was used. All figures are weighted averages.

Source: Bank Examination Reports.

Question 6

Table 7

Nonperforming Assets as a Percentage of Total Assets[1]

State Member Banks

As of Year-End	Asset Size Class Less Than $300 Million	 $300 Million-$1 Billion	 Greater Than $1 Billion	All State Member Banks
1984	1.73	1.34	2.03	1.95
1983	1.66	1.26	1.89	1.83
1982	1.73	1.75	1.78	1.78

---

[1] Nonperforming assets are defined as loans and leases past due 90 days or more and still accruing, nonaccrual and renegotiated loans and leases, and other real estate owned. All figures are weighted averages.

Source: Call Report.

Question 7

Table 8

Classified Energy Loans as a Percentage of Equity Plus Loan Loss Reserves[1]

State Member Banks

	Asset Size Class			
	Less Than $300 Million	$300 Million- $1 Billion	Greater Than $1 Billion	All State Member Banks
1984	0	0	1.96	1.94
1983	.52	0	1.55	1.53
1982	0	0	.17	.16
1981	0	0	.08	.08
1980	0	0	.06	.06
1979	0	0	.15	.15
1978	0	0	.36	.35
1977	0	0	.20	.20

---

[1] The ratios represent classified loans in the Shared National Credit Program weighted on the basis of 20 percent of substandard loans plus 50 percent of doubtful loans plus 100 percent of loss loans to equity capital plus loan loss reserves as reflected in the June 30 Call Reports for 1977 through 1984. All figures are weighted averages.

Source: The above information is derived from the annual interagency program for review and classification of Shared National Credits (SNC). A SNC is defined as any loan or group of loans to a borrower aggregating $20 million or more, either outstanding or committed under a formal lending agreement and (a) shared at its inception by two or more banks; or (b) a portion of which is sold to one or more banks with the purchasing bank assuming its pro-rata share of the credit risk. Therefore the above data are not meant to represent the full extent of classified energy credits.

Question 7

Table 9

Classified Real Estate Loans as a Percentage of Equity Plus Loan Loss Reserves[1]

State Member Banks

	Asset Size Class			
	Less Than $300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All State Member Banks
1984	0	0	.29	.29
1983	0	.08	.14	.14
1982	0	.17	.05	.05
1981	0	.09	.09	.09
1980	0	.42	.17	.17
1979	0	0	.11	.11
1978	0	0	.23	.23
1977	.85	.45	.35	.35

---

[1] The ratios represent classified loans in the Shared National Credit Program weighted on the basis of 20 percent of substandard loans plus 50 percent of doubtful loans plus 100 percent of loss loans to equity capital plus loan loss reserves as reflected in the June 30 Call Reports for 1977 through 1984. All figures are weighted averages.

Source: The above information is derived from the annual interagency program for review and classification of Shared National Credits (SNC). A SNC is defined as any loan or group of loans to a borrower aggregating $20 million or more, either outstanding or committed under a formal lending agreement and (a) shared at its inception by two or more banks; or (b) a portion of which is sold to one or more banks with the purchasing bank assuming its pro-rata share of the credit risk. Therefore the above data are not meant to represent the full extent of classified real estate credits.

Question 7

Table 10

Classified Energy Loans as a Percentage of Equity Plus Loan Loss Reserves[1]

National Banks

	Asset Size Class			
	Less Than $300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All National Banks
1984	.41	1.03	3.22	3.13
1983	.35	.87	2.85	2.73
1982	.01	.07	.63	.59
1981	0	0	.40	.37
1980	0	0	.12	.11
1979	.06	.08	.28	.27
1978	0	.01	.43	.40
1977	0	.01	.24	.22

---

[1] The ratios represent classified loans in the Shared National Credit Program weighted on the basis of 20 percent of substandard loans plus 50 percent of doubtful loans plus 100 percent of loss loans to equity capital plus loan loss reserves as reflected in the June 30 Call Reports for 1977 through 1984. All figures are weighted averages.

Source: The above information is derived from the annual interagency program for review and classification of Shared National Credits (SNC). A SNC is defined as any loan or group of loans to a borrower aggregating $20 million or more, either outstanding or committed under a formal lending agreement and (a) shared at its inception by two or more banks; or (b) a portion of which is sold to one or more banks with the purchasing bank assuming its pro-rata share of the credit risk. Therefore the above data are not meant to represent the full extent of classified energy credits.

Question 7

Table 11

Classified Real Estate Loans as a Percentage of Equity Plus Loan Loss Reserves1/

National Banks

	Asset Size Class			
	Less Than $300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All National Banks
1984	.02	.03	.34	.33
1983	.01	.02	.16	.15
1982	.02	.06	.08	.08
1981	.04	.02	.16	.16
1980	.24	.22	.24	.23
1979	.92	.18	.19	.19
1978	.79	.19	.39	.39
1977	.66	.29	.66	.63

1/ The ratios represent classified loans in the Shared National Credit Program weighted on the basis of 20 percent of substandard loans plus 50 percent of doubtful loans plus 100 percent of loss loans to equity capital plus loan loss reserves as reflected in the June 30 Call Reports for 1977 through 1984. All figures are weighted averages.

Source: The above information is derived from the annual interagency program for review and classification of Shared National Credits (SNC). A SNC is defined as any loan or group of loans to a borrower aggregating $20 million or more, either outstanding or committed under a formal lending agreement and (a) shared at its inception by two or more banks; or (b) a portion of which is sold to one or more banks with the purchasing bank assuming its pro-rata share of the credit risk. Therefore the above data are not meant to represent the full extent of classified real estate credits.

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Question 7

Table 12

Classified Energy Loans as a Percentage of Equity Plus Loan Loss Reserves[1/]

State Nonmember Banks

	Asset Size Class			
	Less Than $300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All State Nonmember Banks
1984	1.05	1.14	.24	.57
1983	1.76	2.58	1.29	1.66
1982	.96	.98	.09	.45
1981	0	0	.13	.09
1980	.25	0	.04	.07
1979	0	0	.13	.10
1978	0	.73	.16	.24
1977	0	.81	.14	.29

[1/] The ratios represent classified loans in the Shared National Credit Program weighted on the basis of 20 percent of substandard loans plus 50 percent of doubtful loans plus 100 percent of loss loans to equity capital plus loan loss reserves as reflected in the June 30 Call Reports for 1977 through 1984. All figures are weighted averages.

Source: The above information is derived from the annual interagency program for review and classification of Shared National Credits (SNC). A SNC is defined as any loan or group of loans to a borrower aggregating $20 million or more, either outstanding or committed under a formal lending agreement and (a) shared at its inception by two or more banks; or (b) a portion of which is sold to one or more banks with the purchasing bank assuming its pro-rata share of the credit risk. Therefore the above data are not meant to represent the full extent of classified energy credits.

Question 7

Table 13

Classified Real Estate Loans as a Percentage of Equity Plus Loan Loss Reserves[1]

State Nonmember Banks

	Asset Size Class			
	Less Than $300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All State Nonmember Banks
1984	.42	0	.67	.47
1983	.11	.02	.03	.04
1982	0	0	0	0
1981	.02	.12	.03	.04
1980	.08	.14	.09	.09
1979	.10	.12	.20	.18
1978	.23	.18	.16	.17
1977	1.54	.06	.25	.40

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[1] The ratios represent classified loans in the Shared National Credit Program weighted on the basis of 20 percent of substandard loans plus 50 percent of doubtful loans plus 100 percent of loss loans to equity capital plus loan loss reserves as reflected in the June 30 Call reports for 1977 through 1984. All figures are weighted averages.

Source: The above information is derived from the annual interagency program for review and classification of Shared National Credits (SNC). A SNC is defined as any loan or group of loans to a borrower aggregating $20 million or more, either outstanding or committed under a formal lending agreement and (a) shared at its inception by two or more banks; or (b) a portion of which is sold to one or more banks with the purchasing bank assuming its pro-rata share of the credit risk. Therefore the above data are not meant to represent the full extent of classified real estate credits.

Question 8

Table 14

Volatile Liabilities as a Percentage of Total Assets[1/]

State Member Banks

As of Year-End	Asset Size Class Less Than $300 Million	 $300 Million-$1 Billion	 Greater Than $1 Billion	All State Member Banks
1984	12.69	22.32	52.94	46.80
1983	11.73	20.36	53.51	46.96
1982	13.57	26.15	58.00	51.43
1981	14.18	27.64	58.49	51.69
1980	13.04	23.82	54.66	48.20
1979	13.32	25.78	51.23	45.33
1978	12.43	24.59	51.11	44.48
1977	10.66	18.79	48.14	40.85
1976	10.46	17.69	48.24	39.86

1/ Volatile liabilities are defined as all time deposits over $100 thousand, foreign-office deposits, federal funds purchased and securities sold under agreements to repurchase, interest-bearing demand notes (note balances) issued to the U.S. Treasury, and other liabilities for borrowed money. Data on interest-bearing demand notes issued to the U.S. Treasury have been available only since 1978. All figures are weighted averages.

Source: Call Report.

Question 8

Table 15

Purchased Funds as a Percentage of Total Assets[1/]

Bank Holding Companies With Assets Above $100 Million

As of Year-End	Asset Size Class: $100 Million-$300 Million	Asset Size Class: $300 Million-$1 Billion	Asset Size Class: Greater Than $1 Billion	All BHCs With Assets Above $100 Million
1984	15.75	19.62	40.7[illegible]	38.02
1983	15.97	18.66	43.02	40.11
1982	20.00	22.66	48.28	45.54
1981	22.34	24.92	51.26	48.80
1980	20.18	22.34	49.43	47.04
1979	18.50	19.97	48.34	45.81
1978	17.90	19.35	47.14	44.43
1977	14.73	17.55	44.47	41.35
1976	13.24	18.12	43.66	40.43

[1/] Purchased funds are defined as all time deposits over $100 thousand, foreign-office deposits, federal funds purchased and securities sold under agreements to repurchase, commercial paper, and other borrowings with an original maturity of one year or less. All figures are weighted averages.

Source: Form F.R. Y-9.

Question 9

Table 16

Net Income as a Percentage of Equity[1/]

State Member Banks

	Asset Size Class			
	Less Than $300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All State Member Banks
1984	9.43	12.36	11.96	11.58
1983	8.01	10.69	12.70	11.58
1982	10.48	12.48	12.10	11.85
1981	10.88	12.03	13.06	12.58
1980	11.89	11.85	13.24	12.87
1979	12.09	12.47	11.88	11.98
1978	11.92	12.36	10.67	11.07
1977	11.42	11.40	9.54	10.11
1976	10.46	10.61	9.79	10.04
1975	10.45	10.62	10.97	10.81
1974	10.92	11.98	11.89	11.68
1973	11.71	12.84	11.65	11.84
1972	11.55	12.53	11.00	11.36
1971	11.74	13.29	11.52	11.87
1970	11.72	13.75	10.90	11.58

1/ All figures are weighted averages.

Source: Call Report.

Question 9

Table 17

Net Income as a Percentage of Total Assets[1/]

State Member Banks

	Asset Size Class			
	Less Than $300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All State Member Banks
1984	0.77	0.88	0.59	0.62
1983	0.84	0.81	0.60	0.64
1982	0.86	0.84	0.54	0.59
1981	0.89	0.81	0.57	0.62
1980	0.97	0.85	0.56	0.62
1979	0.97	0.89	0.50	0.58
1978	0.93	0.89	0.47	0.56
1977	0.88	0.82	0.45	0.53
1976	0.81	0.79	0.46	0.55
1975	0.79	0.77	0.49	0.57
1974	0.82	0.88	0.51	0.60
1973	0.86	0.89	0.51	0.61
1972	0.83	0.87	0.53	0.63
1971	0.86	0.98	0.61	0.71
1970	0.88	1.05	0.61	0.73

[1/] All figures are weighted averages.

Source: Call Report.

Question 9

Table 18

Net Income as a Percentage of Equity

Bank Holding Companies With Assets Above $100 Million[1/]

	Asset Size Class			
	$100 Million-$300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All BHCs With Assets Above $100 Million
1984	10.12	10.62	9.88	9.95
1983	9.19	11.09	11.24	11.11
1982	11.79	10.63	11.75	11.66
1981	12.82	11.24	12.60	12.51
1980	12.62	12.32	13.06	12.98
1979	13.68	13.13	13.49	13.47
1978	12.65	12.19	12.61	12.58
1977	11.05	10.44	11.48	11.34
1976	10.99	10.18	11.16	11.04
1975	10.52	9.21	11.13	10.86

[1/] All figures are weighted averages.

Source: Form F.R. Y-9.

Question 9

Table 19

Net Income as a Percentage of Total Assets

Bank Holding Companies With Assets Above $100 Million[1]

	Asset Size Class			
	$100 Million-$300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All BHCs With Assets Above $100 Million
1984	0.68	0.70	0.53	0.55
1983	0.61	0.74	0.59	0.60
1982	0.78	0.69	0.58	0.59
1981	0.83	0.72	0.59	0.61
1980	0.82	0.79	0.60	0.61
1979	0.85	0.84	0.61	0.63
1978	0.77	0.77	0.58	0.60
1977	0.72	0.71	0.55	0.57
1976	0.73	0.69	0.55	0.57
1975	0.71	0.62	0.55	0.57

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[1] All figures are weighted averages.

Source: Form F.R. Y-9.

Question 10

Table 20

Nonperforming Real Estate Loans as a Percentage of Equity and Loan Loss Reserves[1]

State Member Banks With Assets Above $100 Million

As of Year-End	Asset Size Class $100 Million-$300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All State Member Banks With Assets Above $100 Million
1984	5.70	4.73	5.06	5.06
1983	6.29	6.31	5.54	5.68
1982	7.13	8.22	7.38	7.43

---

[1] Nonperforming real estate loans are defined as real estate loans past due 90 days or more and still accruing, and nonaccrual and renegotiated real estate loans. Data are only available for banks with assets greater than $100 million. All figures are weighted averages.

Source: Call Report.

Question 10

Table 21

Nonperforming Real Estate Loans as a Percentage of Equity and Loan Loss Reserves[1/]

National Banks With Assets Above $100 Million

As of Year-End	Asset Size Class $100 Million-$300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All Banks Greater Than $100 Million
1984	5.15	5.17	6.40	6.14
1983	5.02	4.87	7.18	6.64
1982	5.94	6.57	9.54	8.73

1/ Nonperforming real estate loans are defined as real estate loans past due 90 days or more and still accruing, and nonaccrual and renegotiated real estate loans. Data are only available for banks with assets greater than $100 million. All figures are weighted averages.

Source: Call Report.

Question 10

Table 22

Nonperforming Real Estate Loans as a Percentage of Equity and Loan Loss Reserves[1]

State Nonmember Banks With Assets Above $100 Million

As of Year-End	Asset Size Class $100 Million-$300 Million	 $300 Million-$1 Billion	 Greater Than $1 Billion	All Banks Greater Than $100 Million
1984	6.05	8.34	6.83	7.00
1983	5.76	8.42	9.71	7.60
1982	7.52	11.53	13.12	10.12

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[1] Nonperforming real estate loans are defined as real estate loans past due 90 days or more and still accruing, and nonaccrual and renegotiated real estate loans. Data are only available for banks with assets greater than $100 million. All figures are weighted averages.

Source: Call Report.

Question 10

Table 23

Real Estate Loan Net Charge-Offs as a Percentage of Equity and Loan Loss Reserves[1/]

State Member Banks With Assets Above $300 Million

	Asset Size Class		
	$300 Million-$1 Billion	Greater Than $1 Billion	All State Member Banks With Assets Above $300 Million
1984	0.16	0.20	0.20
1983	0.28	0.15	0.16
1982	0.50	0.16	0.19
1981	0.30	0.02	0.04
1980	1.06	0.03	0.13
1979	0.49	0.24	0.27
1978	0.21	0.70	0.64
1977	0.25	0.74	0.68
1976	1.28	1.39	1.38

1/ From 1976 through 1983, data are only available for banks with assets greater than $300 million. In 1984, the ratio for state member banks with assets less than $300 million was 0.53 percent. All figures are weighted averages.

Source: Call Report.

Question 10

Table 24

Real Estate Loan Net Charge-Offs as a Percentage of Equity and Loan Loss Reserves[1]

	National Banks With Assets Above $300 Million		
	Asset Size Class		
	$300 Million-$1 Billion	Greater Than $1 Billion	All National Banks With Assets Above $300 Million
1984	0.33	0.60	0.57
1983	0.31	0.36	0.36
1982	0.34	0.21	0.23
1981	0.17	0.11	0.12
1980	0.08	0.07	0.07
1979	0.19	0.22	0.22
1978	0.33	0.65	0.60
1977	0.53	0.69	0.66
1976	0.87	1.03	1.00

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[1] From 1976 through 1983, data are only available for banks with assets greater than $300 million. In 1984, the ratio for national banks with assets less than $300 million was 0.45 percent. All figures are weighted averages.

Source: Call Report.

Question 10

Table 25

Real Estate Loan Net Charge-Offs as a Percentage of Equity and Loan Loss Reserves[1]

State Nonmember Banks With Assets Above $300 Million

	Asset Size Class		
	$300 Million-$1 Billion	Greater Than $1 Billion	All State Nonmember Banks With Assets Above $300 Million
1984	0.65	0.60	0.63
1983	0.37	0.30	0.33
1982	0.57	0.29	0.43
1981	0.41	0.27	0.35
1980	0.15	0.19	0.17
1979	0.27	0.33	0.30
1978	0.42	0.81	0.32
1977	0.64	0.61	0.63
1976	1.10	0.46	0.81

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[1] From 1976 through 1983, data are only available for banks with assets greater than $300 million. In 1984, the ratio for state nonmember banks with assets less than $300 million was 0.65 percent. All figures are weighted averages.

Source: Call Report.

Question 10

Table 26

Nonperforming Agricultural Loans as a Percentage of Equity and Loan Loss Reserves[1]

Reporting State Member Banks With Assets Above $100 Million

As of Year-End	Asset Size Class $100 Million-$300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All Reporting State Member Banks With Assets Above $100 Million
1984	5.05	2.81	0.36	0.63
1983	1.47	1.10	0.54	0.77
1982	2.92	0.87	0.41	0.61

1/ Nonperforming agricultural loans equal the sum of agricultural loans past due 90 days or more and still accruing, and nonaccrual and renegotiated agricultural loans. Data are only available for banks with assets greater than $100 million. In 1982 and 1983, only banks with domestic office agricultural loans greater than one percent of domestic office loans reported these data. In 1984, only banks with domestic office agricultural loans greater than five percent of domestic office loans reported these data. All figures are weighted averages.

Source: Call Report.

Question 10

Table 27

Nonperforming Agricultural Loans as a Percentage of Equity and Loan Loss Reserves[1/]

Reporting National Banks With Assets Above $100 Million

As of Year-End	Asset Size Class $100 Million-$300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All Reporting National Banks With Assets Above $100 Million
1984	8.55	2.43	2.49	2.85
1983	3.93	2.52	2.85	2.91
1982	3.23	2.82	2.31	2.44

1/ Nonperforming agricultural loans equal the sum of agricultural loans past due 90 days or more and still accruing, and nonaccrual and renegotiated agricultural loans. Data are only available for banks with assets greater than $100 million. In 1982 and 1983, only banks with domestic office agricultural loans greater than one percent of domestic office loans reported these data. In 1984, only banks with domestic office agricultural loans greater than five percent of domestic office loans reported these data. All figures are weighted averages.

Source: Call Report.

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Question 10

Table 28

Nonperforming Agricultural Loans as a Percentage of Equity and Loan Loss Reserves[1/]

	Reporting State Nonmember Banks With Assets Above $100 Million			
	Asset Size Class			
As of Year-End	$100 Million-$300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All Reporting State Nonmember Banks With Assets Above $100 Million
1984	5.94	1.71	0.81	2.24
1983	3.58	1.13	0.83	1.17
1982	2.25	1.32	1.17	1.59

1/ Nonperforming agricultural loans equal the sum of agricultural loans past due 90 days or more and still accruing, and nonaccrual and renegotiated agricultural loans. Data are only available for banks with assets greater than $100 million. In 1982 and 1983, only banks with domestic office agricultural loans greater than one percent of domestic office loans reported these data. In 1984, only banks with domestic office agricultural loans greater than five percent of domestic office loans reported these data. All figures are weighted averages.

Source: Call Report.

Question 10

Table 29

Agricultural Net Charge-Offs as a Percentage of Equity and Loan Loss Reserves[1]

	Reporting State Member Banks			
	Asset Size Class			
	Less Than $300 Million[2]	$300 Million-$1 Billion	Greater Than $1 Billion	All Reporting State Member Banks
1984	3.06	0.41	0.00	0.16

---

[1] All figures are weighted averages.

[2] For banks with assets less than $300 million, only those with agricultural loans greater than five percent of total loans reported these data.

Source: Call Report.

Question 10

Table 30

Agricultural Net Charge-Offs as a Percentage of Equity and Loan Loss Reserves[1]

Reporting National Banks

	Asset Size Class			
	Less Than $300 Million[2]	$300 Million-$1 Billion	Greater Than $1 Billion	All Reporting National Banks
1984	4.01	0.31	0.49	0.71

---

[1] All figures are weighted averages.

[2] For banks with assets less than $300 million, only those with agricultural loans greater than five percent of total loans reported these data.

Source: Call Report.

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Question 10

Table 31

Agricultural Net Charge-Offs as a Percentage of Equity and Loan Loss Reserves[1]

Reporting State Nonmember Banks

	Asset Size Class			
	Less Than $300 Million[2]	$300 Million-$1 Billion	Greater Than $1 Billion	All Reporting State Nonmember Banks
1984	4.12	0.08	0.07	1.59

---

[1] All figures are weighted averages.

[2] For banks with assets less than $300 million, only those with agricultural loans greater than five percent of total loans reported these data.

Source: Call Report.

Question 10

Table 32

Nonperforming Foreign Office Loans as a Percentage of Equity and Loan Loss Reserves[1]

State Member Banks With Foreign Offices

As of Year-End	
1984	17.73
1983	9.21
1982	7.71

---

[1] Nonperforming foreign office loans are defined as foreign office loans past due 90 days or more and still accruing, and nonaccrual loans and renegotiated foreign office loans. No size classes were used as virtually all of these banks exceed $1 billion in assets. All figures are weighted averages.

Source: Call Report.

Question 10

Table 33

Nonperforming Foreign Office Loans as a Percentage of Equity and Loan Loss Reserves[1]

National Banks With Foreign Offices

As of Year-End	
1984	16.53
1983	13.44
1982	11.52

1/ Nonperforming foreign office loans are defined as foreign office loans past due 90 days or more and still accruing, and nonaccrual loans and renegotiated foreign office loans. No size classes were used as virtually all of these banks exceed $1 billion in assets. All figures are weighted averages.

Source: Call Report.

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Question 10

Table 34

Nonperforming Foreign Office Loans as a Percentage of Equity and Loan Loss Reserves[1]

State Nonmember Banks With Foreign Offices

As of Year-End	
1984	6.00
1983	3.71
1982	3.90

---

[1] Nonperforming foreign office loans are defined as foreign office loans past due 90 days or more and still accruing, and nonaccrual loans and renegotiated foreign office loans. No size classes were used as virtually all of these banks exceed $1 billion in assets. All figures are weighted averages.

Source: Call Report.

Question 10

Table 35

International Loan Net Charge-Offs as a Percentage of Equity and Loan Loss Reserves[1/]

State Member Banks With Foreign Offices	
1984	1.08
1983	1.03
1982	0.89
1981	0.37
1980	0.15
1979	0.44
1978	0.47

[1/] International loans as defined as commercial and industrial loans to non-U.S. addressees, loans to foreign banks, and loans to foreign governments and official institutions. No size classes were used as virtually all of these banks exceed $1 billion in assets. All figures are weighted averages.

Source: Call Report.

Question 10

Table 36

International Loan Net Charge-Offs as a Percentage of Equity and Loan Loss Reserves[1]

National Banks With Foreign Offices	
1984	2.05
1983	1.94
1982	1.20
1981	0.61
1980	0.57
1979	0.45
1978	0.60

---

[1] International loans as defined as commercial and industrial loans to non-U.S. addressees, loans to foreign banks, and loans to foreign governments and official institutions. No size classes were used as virtually all of these banks exceed $1 billion in assets. All figures are weighted averages.

Source: Call Report.

Question 10

Table 37

International Loan Net Charge-Offs as a Percentage of Equity and Loan Loss Reserves[1]

	State Nonmember Banks With Foreign Offices
1984	1.05
1983	2.21
1982	1.61
1981	2.13
1980	0.03
1979	(0.23)
1978	0.03

---

[1] International loans as defined as commercial and industrial loans to non-U.S. addressees, loans to foreign banks, and loans to foreign governments and official institutions. No size classes were used as virtually all of these banks exceed $1 billion in assets. All figures are weighted averages.

Numbers in parentheses represent net recoveries.

Source: Call Report.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

November 6, 1985

The Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions Supervision,
Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Chairman St Germain:

In further response to your letter of August 1, a packet of tables is enclosed providing bank holding company inspection data. As indicated in my letter of September 4, this material was not included in our previous submission because the bank holding company inspection data were not then available in a computerized data base.

Please let me know if I can be of further assistance.

Sincerely,

Paul A Volcker

Enclosure

Question 4

Table 1

Inspection-Determined Primary Capital Before and After Adjustment for Weighted Classified Assets as a Percentage of Total Assets[1]

Bank Holding Companies With Assets Above $150 Million

As of Year-End	Asset Size Class: $150 Million - $300 Million: Primary Capital to Assets	Asset Size Class: $150 Million - $300 Million: Adjusted Primary Capital to Assets	Asset Size Class: $300 Million - $1 Billion: Primary Capital to Assets	Asset Size Class: $300 Million - $1 Billion: Adjusted Primary Capital to Assets	Asset Size Class: Greater Than $1 Billion: Primary Capital to Assets	Asset Size Class: Greater Than $1 Billion: Adjusted Primary Capital to Assets	All BHCs with Assets Above $150 Million: Primary Capital to Assets	All BHCs with Assets Above $150 Million: Adjusted Primary Capital to Assets
1984	6.89	6.03	7.08	6.26	6.03	4.96	6.10	5.04
1983	7.07	6.19	7.07	6.25	6.00	4.91	6.07	5.00
1982	7.22	6.53	7.08	6.45	5.75	4.98	5.83	5.08
1981	7.25	6.72	7.06	6.50	5.17	4.61	5.29	4.72
1980	7.54	7.01	6.93	6.41	5.19	4.67	5.29	4.77

---

[1] Weighted classified assets are the sum of defined as 20 percent of substandard assets plus 50 percent of doubtful asset plus 100 percent of loss assets. The most recent inspection as of year-end was used. Due to the intermittent nature of inspection scheduling among bank holding companies, these data do not cover uniform periods, and therefore may differ from capital figures derived from year-end F.R. Y-9 Reports.

Note: Since bank holding companies with low capital ratios and high classifications are more likely to be inspected in any given year than those with high capital ratios and low classifications, the capital ratios shown in this table are biased, and probably understate the capital ratios of bank holding companies for the various categories.

Source: Bank Holding Company Inspection Reports.

Question 5

Table 2

Primary Capital Less Weighted Classified Assets as a Percentage of Total Assets Plus Standby Letters of Credit[1/]

Bank Holding Companies With Assets Above $150 Million

	Asset Size Class			
As of Year-End	$150 Million-$300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All BHCs With Assets Above $150 Million
1984	5.99	6.20	4.68	4.77
1983	6.13	6.20	4.66	4.76
1982	6.48	6.39	4.73	4.84
1981	6.68	6.45	4.43	4.54
1980	6.96	6.38	4.54	4.65

1/ Weighted classified assets are defined as the sum of 20 percent of substandard assets plus 50 percent of doubtful assets plus 100 percent of loss assets. The most recent inspection as of year-end was used. All figures are weighted averages.

Note: Since bank holding companies with low capital ratios and high classifications are more likely to be inspected in any given year than those with high capital ratios and low classifications, the capital ratios shown in this table are biased, and probably understate the capital ratios of bank holding companies for the various categories.

Source: Bank Holding Company Inspection Reports.

Question 6

Table 3

Weighted Classified Assets as a Percentage of Total Assets

Bank Holding Companies With Assets Above $150 Million

As of Year-End	Asset Size Class: Less Than $300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All BHCs With Assets Above $150 Million
1984	0.86	0.82	1.08	1.06
1983	0.89	0.82	1.09	1.07
1982	0.69	0.63	0.76	0.75
1981	0.52	0.55	0.56	0.56
1980	0.54	0.52	0.52	0.52

1/ Weighted classified assets are defined as the sum of 20 percent of substandard assets plus 50 percent of doubtful assets plus 100 percent of loss assets. The most recent inspection as of year-end was used. All figures are weighted averages.

Note: Since bank holding companies with low capital ratios and high classifications are more likely to be inspected in any given year than those with high capital ratios and low classifications, the classified ratios shown in this table are biased, and probably overstate the classified ratios of bank holding companies for the various categories.

Source: Bank Holding Company Inspection Reports.

Question 6

Table 4

Nonperforming Assets as a Percentage of Total Assets[1/]

Bank Holding Companies With Assets Above $150 Million

	Asset Size Class			
As of Year-End	$150 Million-$300 Million	$300 Million-$1 Billion	Greater Than $1 Billion	All Bank Holding Companies
1984	1.76	1.36	1.77	1.76
1983	1.51	1.35	1.52	1.51
1982	2.33	1.27	1.56	1.55
1981	2.09	1.06	1.55	1.54
1980	2.33	0.88	0.83	0.84

[1/] Nonperforming assets are defined as loans and leases past due 90 days or more and still accruing, and nonaccrual and renegotiated loans and leases. Data are generally only available for SEC reporting holding companies. All figures are weighted averages.

Note: Since bank holding companies with high nonperforming assets are more likely to be inspected in any given year than those with low nonperforming assets, the nonperforming ratios shown in this table are biased, and probably overstate the nonperforming ratios of bank holding companies for the various categories.

Source: Bank Holding Company Inspection Reports and individual company annual reports.

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

September 9, 1985

Honorable Fernand J. St Germain
U.S. House of Representatives
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance of the
Committee on Banking, Finance and Urban Affairs
Washington, D.C. 20515

Dear Mr. Chairman:

In response to your written request of August 1 for statistical information related to savings and loan operations, the Bank Board has gathered the attached data.

As noted in discussions held with members of your staff, the information dates back to 1980, which is the earliest period for which our records are computerized. Any information gathered for the years prior to 1980 would involve an extensive manual collection and analysis of written records. There are certain distortions between statistics collected pre- and post-1980. Your office staff has informed us that any pre-1980 statistics the subcommittee may wish to review may be taken from printed volumes of the "Third meeting on the condition of the Financial System", which encompass hearings before the Proxmire committee completed May 23, 1979. Information submitted to the committee from the Board at that time covered institutions in problem book categories. Though the problem book no longer exists, your staff indicated the acceptability of this information.

Additionally, please note that in response to item #10 of your August 1 letter, we have chosen to submit information on problems encountered with state-chartered institutions and their direct investment programs. We feel such information is basic to the Subcommittee's understanding of the current status of savings institutions' financial condition.

Sincerely,

Edwin J. Gray

Attachments

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Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

September 10, 1985

Honorable Fernand J. St Germain
Chairman
House Subcommittee on Financial Institutions
  Supervision, Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

This is in response to your request concerning the aggregate deposits of 4 and 5 rated institutions. Unfortunately, we were not able to generate figures on the deposits of such institutions. Following are aggregate asset figures for such institutions broken down by asset size class for calendar year ends 1980 through 1984. I hope this information is of use to you.

Assets of 4 & 5 Rated Institutions (000's omitted)

	Small	Medium	Large
December 31, 1984	77,201,000	95,696,000	237,141,000
December 31, 1983	65,695,788	71,993,310	164,466,063
December 31, 1982	55,262,536	53,693,618	112,288,110
December 31, 1981	37,512,585	30,297,968	40,642,194
December 31, 1980	10,855,771	6,472,023	7,953,308

Sincerely,

Edwin J. Gray

Federal Home Loan Bank Board

OFFICE OF CONGRESSIONAL RELATIONS

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

September 10, 1985

Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance, and
Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

Attached is a written summation of the additional numbers we gave to your staff over the phone on Monday evening. I hope this provides the materials you need.

Sincerely,

L. Arlen Withers
Director

Attachments

Primary capital less classified assets as a percent of total assets.

		Institution Size		
Year	**Total**	**Small**	**Medium**	**Large**
1984	3.15%	3.66%	3.10%	2.99%
1983	3.40	3.64%	3.18%	3.34%
1982	3.24	3.87%	2.94%	2.82%
1981	4.06	4.67%	3.81%	3.79%
1980	5.10	5.57%	4.86%	4.95%

Definitions

Small - less than $300 million in assets.

Medium - $300 million to $1 billion in assets.

Large - more than $1 billion in assets.

Primary capital - net worth minus qualifying subordinated debentures, net worth certificates, income capital certificates and appraised equity capital.

Classified Assets - 20 percent of scheduled items, the latter as defined in Section 561.15 of the Rules and Regulations for the FSLIC.

Sources

1980 - 1983 - Semiannual FHLBB report data.
1984 - Quarterly FHLBB report data.

Primary capital as a percent of total assets.
Goodwill and other intangibles as a percent of total assets.

		Primary Capital to Total Assets Institution Size			Goodwill and other Intangibles to Total Assets: All Institutions
Year	Total	Small	Medium	Large	
1984	3.44	3.99%	3.34%	3.22%	2.45%
1983	3.70	4.02%	3.50%	3.62%	2.70%
1982	3.52	4.22%	3.25%	3.11%	2.41%
1981	4.27	4.92%	4.03%	3.99%	0.27%
1980	5.26	5.78%	5.03%	5.08%	0.03%

Definitions

Small - less than $300 million in assets.

Medium - $300 million to $1 billion in assets.

Large - more than $1 billion in assets.

Primary capital - net worth minus qualifying subordinated debentures, net worth certificates, income capital certificates and appraised equity capital.

Sources

1980 - 1983 - Semiannual FHLBB report data.
1984 - Quarterly FHLBB report data.

1. Number of problem organizations.

	Institution Size			
Year	Small	Medium	Large	Total
1984	755	180	89	1,024
1983	691	136	68	895
1982	643	102	53	798
1981	458	63	23	544
1980	142	12	5	159

Definitions

Small - less than $300 million in assets.

Medium - $300 million to $1 billion in assets.

Large - more than $1 billion in assets.

Problem organizations - Institutions rated "4" and "5" as of year-end.

Source

ETWRS - Examination Tracking and Workload Reporting System for the FHLBB.

2. Number and total assets of organizations failed or absorbed to avert failure.

	Institution Size*					
	Small		Medium		Large	
Year	Assets	No	Assets	No	Assets	No
1984	$3,031,473	45	$3,470,210	6	$7,975,178	3
1983	$6,116,716	86	$3,837,774	8	$ 0	0
1982	$17,027,986	220	$12,341,161	24	$4,901,786	4
1981	$4,607,583	82	$2,932,614	5	$7,365,699	4

	Supervisory		Assisted***	
	Assets	No	Assets	No
1980**	$1,157,000	21	$1,421,000	11

* Data includes institutions merged with FSLIC assistance.

** 1980 data not available by asset classes or examination rating.

*** Mergers in which FSLIC assistance was necessary.

Definitions

Total assets - as of year-end prior to merger date in thousands.

Small - Less than $300 million in assets.

Medium - $300 million to $1 billion in assets.

Large - More than $1 billion in assets.

Sources

For number of institutions - ETWRS - Examination Tracking and Workload Reporting System for the FHLBB.

For year-end asset figures - Semiannual FHLBB report data.

3. Primary capital as a percent of total assets.
   Goodwill and other intangibles as a percent of total assets.

	Primary Capital to Total Assets Institution Size			Goodwill and other Intangibles to Total Assets: All Institutions
Year	**Small**	**Medium**	**Large**	
1984	3.99%	3.34%	3.22%	2.45%
1983	4.02%	3.50%	3.62%	2.70%
1982	4.22%	3.25%	3.11%	2.41%
1981	4.92%	4.03%	3.99%	0.27%
1980	5.78%	5.03%	5.08%	0.03%

Definitions

Small - less than $300 million in assets.

Medium - $300 million to $1 billion in assets.

Large - more than $1 billion in assets.

Primary capital - net worth minus qualifying subordinated debentures, net worth certificates, income capital certificates and appraised equity capital.

Sources

1980 - 1983 - Semiannual FHLBB report data.
1984 - Quarterly FHLBB report data.

4. Primary capital less classified assets as a percent of total assets.

	Institution Size		
Year	Small	Medium	Large
1984	3.66%	3.10%	2.99%
1983	3.64%	3.18%	3.34%
1982	3.87%	2.94%	2.82%
1981	4.67%	3.81%	3.79%
1980	5.57%	4.86%	4.95%

Definitions

Small - less than $300 million in assets.

Medium - $300 million to $1 billion in assets.

Large - more than $1 billion in assets.

Primary capital - net worth minus qualifying subordinated debentures, net worth certificates, income capital certificates and appraised equity capital.

Classified Assets - 20 percent of scheduled items, the latter as defined in Section 561.15 of the Rules and Regulations for the FSLIC.

Sources

1980 - 1983 - Semiannual FHLBB report data.
1984 - Quarterly FHLBB report data.

5. Primary capital less classified assets as a percent of total assets including standby letters of credit and other off-balance sheet items.

This information is not provided since the Board does not collect data relative to separate statistics on standby letters of credit or other off-balance sheet items.

6. Classified assets and nonperforming assets as a percent of total assets.

	Institution Size		
Year	**Small**	**Medium**	**Large**
1984	0.33%	0.25%	0.23%
1983	0.38%	0.32%	0.28%
1982	0.35%	0.31%	0.29%
1981	0.25%	0.22%	0.20%
1980	0.21%	0.17%	0.13%

Definitions

Small - less than $300 million in assets.

Medium - $300 million to $1 billion in assets.

Large - More than $1 billion in assets.

Classified assets - 20 percent of scheduled items, the latter as defined in Section 561.15 of the Rules and Regulations for the FSLIC. Nonperforming assets are included in the definition of scheduled items.

Sources

1980 - 1983 - Semiannual FHLBB report data.
1984 - Quarterly FHLBB report data.

7. Classified and nonperforming energy loans, agricultural loans, international loans and real estate development loans and investments, each as a percent of primary capital.

Year	Institution Size		
	Small	Medium	Large
1984	8.27%	7.37%	7.14%
1983	9.40%	9.03%	7.85%
1982	8.29%	9.54%	9.39%
1981	5.04%	5.56%	5.01%
1980	3.67%	3.42%	2.48%

Definitions

Small - less than $300 million in assets.

Medium - $300 million to $1 billion in assets.

Large - More than $1 billion in assets.

Classified and nonperforming loans of each type - 20 percent of scheduled items, the latter as defined in Section 561.15 of the Rules and Regulations for the FSLIC. Loan types are not separately presented as a percent of primary capital because data on energy, agricultural and international loans is not individually collected. Such loans, if authorized, would be placed in a general commercial loan category.

Primary Capital - net worth minus qualifying subordinated debentures, net worth certificates, income capital certificates and appraised equity capital.

Sources

1980 - 1983 - Semiannual FHLBB report data.
1984 - Quarterly FHLBB report data.

8. Purchased funds and brokered deposits, each as a percent of total assets.

Year	Brokered Deposits*	Other Borrowings	Jumbo Deposits*
1984	4.27%	6.70%	11.40 %
1983	3.65%	4.20%	9.84%
1982	1.19%	4.14%	8.09%
1981	0.51%	3.39%	7.42%
1980	0.64%	2.02%	6.57%

* Jumbo deposits may include brokered deposits as conversely, brokered deposits may include jumbo deposits.

Definitions

Other Borrowings - Borrowings from all sources other than a FHLBank including commercial bank loans, reverse repurchase agreements, consumer retail repurchase agreements, overdrafts in demand deposits, commercial paper issued, subordinated debentures not qualifying for net worth and mortgage-backed bonds issued.

Jumbo Deposits - Deposits and Certificate Accounts with balances in excess of $100,000 for the year 1984; with balances of $100,000 or more for the years 1980 - 1983.

Sources

1980 - 1983 - Semiannual FHLBB report data.
1984 - Quarterly FHLBB report data.

9. Net income as a percent of equity capital and/or assets: return on assets (ROA) for all institutions; return on equity (ROE) for stock institutions.

Year	Aggregate ROA	Aggregate ROE
1984	0.20%	5.717%*
1983	0.37%	13.288%
1982	(0.65)%	(10.485)%
1981	(0.73)%	(14.474)%
1980	0.13%	4.809%
1979	0.67%	
1978	0.82%	
1977	0.77%	
1976	0.63%	
1975	0.47%	
1974	0.54%	
1973	0.76%	
1972	0.77%	
1971	0.71%	
1970	0.57%	

Definitions

ROA - net income as a percent of average assets.

ROE - net income as a percent of ending net worth, except in 1984 where net income is a percent of beginning net worth. * 1984 ROE is an average of 2nd, 3rd and 4th quarters only.

Source

For ROA - Office of Policy and Economic Research (OPER) - 1984 Savings and Home Financing Source Book.

For ROE - 1980 - 1983 - Semiannual FHLBB report data.
1984 - Quarterly FHLBB report data.

10. Any other information that would augment the Subcommittee's understanding of the current status of the financial condition generally of depository institutions.

The Board chooses to discuss problems related to direct investments, most especially those made by state-chartered institutions, as such problems are reflective of the pervasive ills affecting the Industry.

Thrift failures in 1984 due to asset quality problems represented 70 percent of total failures. To date in 1985, all 17 FSLIC failures were directly attributable to such problems. The cost of resolving these cases has proved costlier than those involving failure due to interest rate spread problems. In 1984, assistance for asset related failures amounted to 27 percent of total assets of failed thrifts compared to 3 percent for spread related failures. Unfortunately, a forecast of troubled institutions shows that the asset quality failure trend (and therefore the trend towards increased assistance) is continuing.

The penchant of many thrifts toward rapid growth and direct investments has resulted in many unsound investments in speculative assets which inevitably leads to a greater potential for loss. Nowhere is this hazardous phenomenon more apparent than among state-chartered institutions in California and Texas. Broader state charter authority has enabled these institutions to undertake much greater risks through enhanced product and service authorities which far exceed those allowed federally chartered thrifts.

Texas has legislated powers to state-chartered thrifts that include:

1. Powers to make land development loans.
2. Powers to invest in corporate bonds and securities.
3. Broad service corporation investment authority.
4. Broad powers to acquire, subdivide and develop real property for residential and other purposes.

California has completely deregulated the asset powers of state-chartered thrifts. Up to 100% of a California institution's assets may be invested in real estate or in a service corporation. Such leeway has, among others, led to investments in windmill farms, corporate and equity securities, junk bonds and large scale real estate development projects.

An analysis of state chartered institutions in Texas, which are current FSLIC cases or which are projected as FSLIC assistance cases requiring assistance within twelve months reveals that 71 percent of these cases can be directly associated with the abuse and misuse of the direct investment authority.

The most common abuse committed by these institutions has been the investment of a substantial portion of their resources in the organization of, or participation in, loans, for the acquisition and development of real estate, including the construction of improvements thereon. In most cases the loans were based on appraisals predicated on "land-flips". Generally the loans or investments portrayed one or more of the following high risk characteristics:

> The lender assumed virtually all of the risk by providing all, or substantially all, of the funds while the borrower, although legally holding title, had little or no equity in the property.
>
> The transaction was structured to maximize front-end profit recognition through the charging of commitment and/or other loan fees which were actually funded by the lender.
>
> Accrued interest was funded by the lender and was recognized as income throughout the term of the project.
>
> Either no arrangements for permanent take-out financing were made or the lender agreed but verbally to convert the loan into some type of permanent financing upon completion of construction.
>
> The lender was a profit participant, usually on a percentage basis, and upon the sale of the project perhaps realized an equity kicker.

The funds for all or a material portion of these loans were obtained from brokered or jumbo savings. In one case, a large state-chartered institution loaned $700 MM for construction projects with the aforementioned high risk characteristics, which were funded by wholesale funds. Of this aggregate total, 70 percent are currently scheduled items or non-performing assets.

There are currently eight California thrift institutions which are FSLIC cases and ten which are projected to be FSLIC cases within 12 months. Of these institutions, at least 15 may be cited for asset quality problems. Most entered into transactions involving speculative construction and real estate development projects which shared the same high-risk characteristics as those described above in the discussion of poor lending practices by Texas thrifts. These institutions, like those in Texas, also placed considerable reliance upon brokered or jumbo savings to fund their projects.

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TOBY ROTH, WISCONSIN

September 16, 1985

SUBCOMMITTEE NOTICE

TO: All Members, Subcommittee on Financial Institutions Supervision, Regulation and Insurance

FROM: Fernand J. St Germain, Chairman

SUBJECT: Revised Federal Home Loan Bank Board (FHLBB) data -- problem institutions.

Attached please find revised FHLBB data relating to the number and total assets of FHLBB institutions 1980 to present. This date supersedes FHLBB's initial data submission dated September 9, 1985 and its subsequent transmittal of problem institution asset information dated September 10, 1985.

BEST COPY AVAILABLE

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

September 16, 1985

RECEIVED
SEP 16 1985
Subcommittee on Financial Institutions

Honorable Fernand J. St Germain
Chairman
House Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I respectfully request that the attached be submitted for the record on the hearings on the state of the industry held September 11, 1985.

In preparation for those hearings, the staff submitted information in response to your inquiry dated August 1, 1985. The response to Question #1, relating to the number of problem institutions, is in error in that they are cumulative; they represent the number of institutions at each year end that were rated 4 or 5 at any time back to 1980, as opposed to being rated 4 or 5 at their most recent examination. Correspondingly, the data on the assets of 4 and 5 rated institutions, provided to the Subcommittee on September 10, 1985, are in error. Those data are also corrected in the attached document.

I regret any inconvenience this may have caused the Subcommittee.

Sincerely,

Edwin J. Gray
Chairman

Attachment

CORRECTION OF INFORMATION SUBMITTED ON SEPTEMBER 9-10, 1985; BY THE FEDERAL HOME LOAN BANK BOARD

1. Number of problem organizations.

	Institution Size			
Year	Small	Medium	Large	Total
1984	544	141	53	738
1983	532	104	42	678
1982	581	93	46	720
1981	427	63	23	513
1980*	142	12	5	159

Definitions

Small - less than $300 million in assets.

Medium - $300 million to $1 billion in assets.

Large - more than $1 billion in assets.

Problem organizations - institutions rated "4" and "5" as of year end.

Source

- ETWRS - Examination Tracking and Workload Reporting System for the FHLBB.

Assets of 4 & 5 Rated Institutions (000's omitted)

	Small	Medium	Large
Dec. 31, 1984	56,085,000	76,882,000	147,419,000
Dec. 31, 1983	50,156,506	53,237,168	98,290,101
Dec. 31, 1982	50,509,754	49,511,914	101,230,397
Dec. 31, 1981	35,636,976	30,601,951	40,642,194
Dec. 31, 1980	10,855,771	6,472,023	7,953,308

* 1980 Data for 4th quarter only. Prior data unavailable.

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

September 6, 1985

Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
  Supervision, Regulation and Insurance
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

The data that you requested for national banks in your letter of August 1, 1985 are enclosed for your information. The time series of the data, the size categories of national banks, and the data definitions are as agreed upon with your staff.

We are pleased to provide you with this information.

Sincerely,

H. Joe Selby
Acting Comptroller of the Currency

Enclosure

Office of the Comptroller of the Currency

Response to Letter dated August 1, 1985 from
U.S. House of Representatives
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
of the
Committee on Banking, Finance and Urban Affairs

Question 1.

NUMBER AND TOTAL ASSETS OF "PROBLEM ORGANIZATIONS."

Data to be provided by the Federal Deposit Insurance Corporation.

Question 2

NUMBER AND ASSETS OF NATIONAL BANKS FAILED OR ABSORBED TO AVERT FAILURE

National Banks
(Size Categories by Total Assets)
($ millions)

Year	Under $300 million #	Under $300 million Assets	$300 million-$1 billion #	$300 million-$1 billion Assets	Over $1 billion #	Over $1 billion Assets	Total #	Total Assets
1984	17	$555.1	0	-	0	-	17	$555.1
1983	8	406.7	0	-	1	$1,547.5	9	1,954.2
1982	8	318.4	2	986.1	0	-	10	1,304.5
1981	1	10.6	0	-	0	-	1	10.6
1980	1	12.5	0	-	0	-	1	12.5
1979	3	68.8	0	-	0	-	3	68.8
1978	1	226.8	0	-	0	-	1	226.8
1977	1	6.3	0	-	0	-	1	6.3
1976	1	2.6	1	412.1	0	-	2	417.7
1975	2	155.1	0	-	0	..	2	155.1
1974	0	-	0	-	1	3,655.6	1	3,655.7
1973	2	14.6	0	-	1	1,265.9	3	1,280.5
1972	0	-	0	-	0	-	0	-
1971	1	1.3	0	-	0	-	1	1.3
1970	1	21.4	0	-	0	-	1	21.4

Hyphen indicates data not available.

Source: FDIC, Reports of Examination.

Question 3

PRIMARY CAPITAL AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	8.59%	7.46%	6.05%	6.62%
1983	8.50	7.40	5.66	6.34
1982	8.53	7.36	5.37	6.13
1981	8.50	7.32	5.22	6.03
1980	8.44	7.33	5.18	6.02
1979	8.27	7.12	5.18	6.00
1978	8.09	7.00	5.23	6.05
1977	7.91	7.07	5.34	6.15
1976	8.08	7.14	5.56	6.39
1975	8.06	7.29	5.55	6.42
1974	8.06	7.10	5.19	6.16
1973	7.81	6.98	5.38	6.24
1972	7.71	7.21	5.90	6.62
1971	7.93	7.66	6.42	7.07
1970	8.22	8.00	6.74	7.41

Definition: Aggregate year-end primary capital (total equity capital + allowance for loan and lease losses for 1976-1984, reserves on loans for 1970-1975) divided by aggregate year-end total assets.

Source: Call Reports.

Question 3

PRIMARY CAPITAL (AS OF EXAMINATION DATE) AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	8.66%	7.42%	5.73%	6.45%
1983	8.60	7.42	5.65	6.37
1982	8.66	7.45	5.32	6.15
1981	8.65	7.55	5.20	6.10
1980	8.55	7.47	5.12	6.03
1979	8.38	7.34	5.21	6.07
1978	7.76	6.92	4.97	5.83
1977	7.66	6.94	4.97	5.82
1976	7.54	6.77	4.77	5.81
1975	7.56	6.69	4.77	5.76
1974	7.38	6.44	4.68	5.62
1973	7.33	6.80	5.29	6.11
1972	7.52	7.37	6.16	6.77
1971	7.70	7.54	6.23	6.91
1970	7.98	8.04	6.81	7.43

Note: The data used to calculate these ratios were obtained from examination reports rather than call reports. As a result of the intermittent nature of exam scheduling among banks, these data do not cover uniform periods. Therefore the data may differ from statistics obtained from year-end call reports.

Definition: Aggregate primary capital at examination date (gross capital funds - subordinated debt 1979-1984, total equity + reserves on loans 1970-1978) divided by aggregate total assets.

Source: 1979-1984, OCC.
1970-1978, FRB.

Question 4

PRIMARY CAPITAL (AS OF EXAMINATION DATE) LESS CLASSIFIED ASSETS, AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	7.80%	6.73%	4.44%	5.29%
1983	7.84	6.65	4.34	5.21
1982	7.99	6.69	4.34	5.25
1981	8.15	7.04	4.57	5.95
1980	8.10	7.03	4.58	5.50
1979	8.00	6.95	4.61	5.54
1978	7.36	6.41	4.20	5.17
1977	7.22	6.29	4.02	5.02
1976	7.04	5.96	3.27	4.68
1975	7.08	5.85	3.28	4.62
1974	7.05	5.94	3.85	4.96
1973	7.09	6.46	4.75	5.69
1972	7.26	6.92	5.61	6.32
1971	7.40	7.10	5.64	6.44
1970	7.66	7.63	6.39	7.05

Note: The data used to calculate these ratios were obtained from examination reports rather than call reports. As a result of the intermittent nature of exam scheduling among banks, these data do not cover uniform periods. Therefore the data may differ from statistics obtained from year-end call reports.

Definition: Aggregate primary capital at examination date (gross capital funds - subordinated debt 1979-1984, total equity + reserves on loans 1970-1978) minus aggregate classified assets (20% of substandard + 50% of doubtful + 100% of loss) divided by aggregate total assets.

Source: 1979-1984, OCC.
1970-1978, FRB.

Question 5

PRIMARY CAPITAL (AS OF EXAMINATION DATE) LESS CLASSIFIED ASSETS, AS A PERCENT OF TOTAL ASSETS INCLUDING STANDBY LETTERS OF CREDIT

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	7.75%	6.64%	4.17%	5.05%
1983	7.79	6.55	4.08	4.98
1982	7.95	6.59	4.11	5.04
1981	8.12	6.96	4.37	5.31
1980	8.08	6.96	4.43	5.36
1979	7.98	6.90	4.48	5.43
1978	7.36	6.40	4.20	5.17
1977	7.21	6.27	4.01	5.01
1976	7.02	5.91	3.17	4.59
1975	7.07	5.80	3.15	4.50
1974	7.03	5.88	3.71	4.84

Note: The data used to calculate these ratios were obtained from examination reports rather than call reports. As a result of the intermittent nature of exam scheduling among banks, these data do not cover uniform periods. Therefore the data may differ from statistics obtained from year-end call reports.

Standby letters of credit were not reported before 1974.

Definition: Aggregate primary capital at examination date (gross capital funds - subordinated debt 1979-1984, total equity + reserves on loans 1974-1978) minus aggregate classified assets (20% of substandard + 50% of doubtful + 100% of loss), divided by aggregate total assets plus standby letters of credit.

Source: 1979-1984, OCC.
1970-1978, FRB.

Question 6

CLASSIFIED ASSETS (AS OF EXAMINATION DATE) AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	0.86%	0.69%	1.29%	1.15%
1983	0.77	0.78	1.31	1.16
1982	0.67	0.76	0.98	0.90
1981	0.50	0.50	0.63	0.60
1980	0.45	0.44	0.53	0.51
1979	0.38	0.39	0.60	0.53
1978	0.40	0.51	0.77	0.66
1977	0.44	0.65	0.95	0.80
1976	0.50	0.81	1.50	1.13
1975	0.47	0.84	1.49	1.14
1974	0.33	0.49	0.83	0.65
1973	0.24	0.34	0.54	0.42
1972	0.26	0.45	0.55	0.44
1971	0.30	0.44	0.59	0.47
1970	0.32	0.41	0.41	0.38

Note: The data used to calculate these ratios were obtained from examination reports rather than call reports. As a result of the intermittent nature of exam scheduling among banks, these data do not cover uniform periods. Therefore the data may differ from statistics obtained from year-end call reports.

Definition: Aggregate classified assets (20% of substandard + 50% of doubtful + 100% of loss), divided by aggregate total assets.

Source: 1979-1984, OCC.
1970-1978, FRB.

Question 6

NONPERFORMING ASSETS AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	1.72%	1.54%	2.42%	2.22%
1983	1.51	1.55	2.58	2.29
1982	1.51	1.74	2.48	2.23

Definitions: Aggregate year-end nonperforming assets divided by aggregate year-end total assets for all banks in category.

Nonperforming Assets = loans and leases past due 90 days or more and still accruing + nonaccrual loans and leases + renegotiated loans and leases + real estate owned other than bank premises.

Source: Call Reports.

Question 7

CLASSIFIED ENERGY LOANS AS A PERCENTAGE OF EQUITY PLUS LOAN LOSS RESERVES

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	.41%	1.03%	3.22%	3.13%
1983	.35	.87	2.85	2.73
1982	.01	.07	.63	.59
1981	0	0	.40	.37
1980	0	0	.12	.11
1979	.06	.08	.28	.27
1978	0	.01	.43	.40
1977	0	.01	.24	.22

Definition: Aggregate year-end classified energy loans in the Shared National Credit Program (20% substandard + 50% doubtful + 100% loss) divided by aggregate year-end total equity + loan loss reserves from previous June Call Report.

Source: FRB, Shared National Credit Program.

Question 7

NONPERFORMING AGRICULTURAL LOANS AS A PERCENTAGE OF EQUITY AND LOAN LOSS RESERVES

Reporting National Banks With Assets Over $100 Million
(Size Categories by Total Assets)

Year	$100 million- $300 million	$300 million- $1 billion	Over $1 billion	Total
1984	8.55%	2.43%	2.49%	2.85%
1983	3.93	2.52	2.85	2.91
1982	3.23	2.82	2.31	2.44

Note: In 1982 and 1983 only banks with agricultural loans greater than 1% of domestic office loans reported these data. In 1984 the threshold was raised to 5%.

Definitions: Aggregate year-end nonperforming agricultural loans divided by aggregate year-end total equity + loan loss reserves.

Nonperforming agricultural loans = agricultural loans past due 90 days or more and still accruing + nonaccrual agricultural loans + renegotiated agricultural loans.

Source: FRB, Call Reports.

Question 7

AGRICULTURAL NET CHARGE-OFFS AS A PERCENTAGE OF EQUITY AND LOAN LOSS RESERVES

Reporting National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	4.01%	0.31%	0.49%	0.71%

Note: For banks under $300 million, only those with agricultural loans greater than 5% of total domestic loans reported these data.

Definition: Aggregate year-end agricultural net charge-offs divided by aggregate year-end total equity + loan loss reserves.

Source: FRB, Call Reports.

Question 7

INTERAGENCY COUNTRY EXPOSURE REVIEW COMMITTEE (ICERC) CLASSIFIED ASSETS AS A PERCENTAGE OF PRIMARY CAPITAL

Year	National Banks	State Member Banks	State Nonmember Banks	Total
1984	1.78%	1.96%	1.13%	1.80%
1983	3.26	4.45	1.05	3.46
1982	2.74	3.82	1.21	2.95

Definition: Aggregate ICERC classified assets (20% of substandard + 50% of value impaired) divided by aggregate primary capital for all banks with ICERC classified assets.

Source: OCC.

Question 7

NONPERFORMING FOREIGN OFFICE LOANS AS A PERCENTAGE OF EQUITY AND LOAN LOSS RESERVES

National Banks With Foreign Offices

Year	Total
1984	16.53%
1983	13.44
1982	11.52

Note: No size categories were used because virtually all banks exceed $1 billion in assets.

Definitions: Aggregate year-end nonperforming foreign office loans divided by aggregate year-end total equity + loan loss reserves.

Nonperforming foreign office loans = foreign office loans past due 90 days or more and still accruing + nonaccrual foreign office loans + renegotiated foreign office loans.

Source: FRB, Call Reports.

Question 7

INTERNATIONAL LOAN NET CHARGE-OFFS AS A PERCENTAGE OF EQUITY AND LOAN LOSS RESERVES

National Banks With Foreign Offices

Year	Total
1984	2.05%
1983	1.94
1982	1.20
1981	0.61
1980	0.57
1979	0.45
1978	0.60

Note: No size categories were used because virtually all banks exceed $1 billion in assets.

Definitions: Aggregate year-end international net loan charge-offs divided by aggregate year-end total equity + loan loss reserves.

International loans = commercial and industrial loans to non-U.S. addressees + loans to foreign banks + loans to foreign governments and official institutions.

Source: FRB, Call Reports.

Question 7

CLASSIFIED REAL ESTATE LOANS AS A PERCENTAGE OF EQUITY PLUS LOAN LOSS RESERVES

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	.02%	.03%	.34%	.33%
1983	.01	.02	.16	.15
1982	.02	.06	.08	.08
1981	.04	.02	.16	.16
1980	.24	.22	.24	.23
1979	.92	.18	.19	.19
1978	.79	.19	.39	.39
1977	.66	.29	.66	.63

Definition: Aggregate year-end classified real estate loans in the Shared National Credit Program (20% substandard + 50% doubtful + 100% loss) divided by aggregate year-end total equity + loan loss reserves from previous June Call Report.

Source: FRB, Shared National Credit Program.

Question 7

NONPERFORMING REAL ESTATE LOANS AS A PERCENTAGE OF EQUITY AND LOAN LOSS RESERVES

National Banks With Assets Over $100 Million
(Size Categories by Total Assets)

Year	$100 million-$300 million	$300 million-$1 billion	Over $1 billion	Total
1984	5.15%	5.17%	6.40%	6.14%
1983	5.02	4.87	7.18	6.64
1982	5.94	6.57	9.54	8.73

Definitions: Aggregate year-end nonperforming real estate loans divided by aggregate year-end total equity + loan loss reserves.

Nonperforming real estate loans = real estate loans past due 90 days or more and still accruing + nonaccrual real estate loans + renegotiated real estate loans.

Source: FRB, Call Reports.

Question 7

REAL ESTATE LOAN NET CHARGE-OFFS AS A PERCENTAGE OF EQUITY AND LOAN LOSS RESERVES

National Banks With Assets Over $300 Million
(Size Categories by Total Assets)

Year	$300 million-$1 billion	Over $1 billion	Total
1984	0.33%	0.60%	0.57%
1983	0.31	0.36	0.36
1982	0.34	0.21	0.23
1981	0.17	0.11	0.12
1980	0.08	0.07	0.07
1979	0.19	0.22	0.22
1978	0.33	0.65	0.60
1977	0.53	0.69	0.66
1976	0.87	1.03	1.00

Definition: Aggregate year-end real estate loan net charge-offs divided by aggregate year-end total equity + loan loss reserves.

Source: FRB, Call Reports.

Question 8

VOLATILE LIABILITIES AS A PERCENTAGE OF TOTAL ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	14.58%	21.55%	44.02%	36.82%
1983	13.56	21.28	47.45	38.99
1982	15.00	26.18	52.51	43.35
1981	15.35	27.11	54.88	45.01
1980	14.30	25.00	54.05	43.68
1979	13.69	24.72	53.54	42.57
1978	13.08	24.78	52.67	41.09
1977	11.24	22.33	50.42	37.93
1976	10.88	21.01	45.70	32.83

Note: Data not available before 1976.

Definitions: Aggregate year-end volatile liabilities divided by aggregate year-end total assets.

Volatile Liabilities = Time Deposits in Denominations of $100,000 or More + Federal Funds Purchased and Securities Sold Under Agreements to Repurchase + Interest Bearing Demand Notes Issued to the U.S. Treasury and Other Liabilities for Borrowed Money (1978-1984), Other Liabilities for Borowed Money (1976-1977) + Total Foreign Deposits.

Source: Call Reports.

Question 8

BROKERED DEPOSITS AS A PERCENTAGE OF TOTAL DEPOSITS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion
1984	0.12%	0.21%	2.91%
1983	0.19	0.28	2.60

Definitions: Aggregate year-end brokered deposits divided by aggregate year-end deposits.

Brokered deposits = deposits received from brokers or dealers for the account of others either directly or ultimately.

Source: FDIC, Call Reports.

Question 9

RETURN ON ASSETS

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	0.77%	0.85%	0.46%	0.55%
1983	0.86	0.76	0.48	0.57
1982	0.91	0.75	0.54	0.63
1981	0.98	0.85	0.58	0.68
1980	1.02	0.86	0.59	0.70
1979	1.00	0.84	0.63	0.73
1978	0.94	0.78	0.60	0.69
1977	0.87	0.71	0.55	0.64
1976	0.85	0.68	0.57	0.65
1975	0.79	0.68	0.59	0.65
1974	0.86	0.71	0.54	0.64
1973	0.87	0.72	0.55	0.66
1972	0.83	0.75	0.58	0.68
1971	0.85	0.81	0.63	0.73
1970	0.89	0.89	0.65	0.76

Definition: Aggregate net income divided by aggregate year-end total assets.

Source: Call Reports.

Question 9

RETURN ON EQUITY

National Banks
(Size Categories by Total Assets)

Year	Under $300 million	$300 million-$1 billion	Over $1 billion	Total
1984	9.69%	12.52%	8.71%	9.32%
1983	10.81	11.28	9.66	10.12
1982	11.43	11.09	11.50	11.44
1981	12.31	12.67	12.54	12.49
1980	12.88	12.75	12.75	12.79
1979	13.01	12.91	13.57	13.33
1978	12.38	12.17	12.66	12.52
1977	11.82	10.90	11.32	11.42
1976	11.19	10.44	11.22	11.10
1975	10.90	10.57	12.39	11.62
1974	11.84	11.37	12.39	12.05
1973	12.43	11.78	12.17	12.20
1972	11.94	11.83	11.50	11.71
1971	11.99	12.07	11.63	11.83
1970	12.14	12.67	11.45	11.90

Definition: Aggregate net income divided by aggregate year-end total equity.

Source: Call Reports.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

September 6, 1985

Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance
and Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

In response to your letter of August 1, I am enclosing the bank data information you requested. Interagency meetings have been held to assure that the information is presented on a consistent basis. Agreement was also reached with your staff relative to the format of the information submitted.

If you have any questions concerning the enclosed material, please do not hesitate to contact me or have a member of your staff contact Assistant Director George J. Masa at 389-4141.

Sincerely,

William M. Isaac
Chairman

Enclosure

Federal Deposit Insurance Corporation

Response to Letter dated August 1, 1985 from

U.S. House of Representatives

Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
of the

Committee on Banking, Finance and Urban Affairs

- Please note in regards to item numbers 1 and 2 of the August 1 letter that the FDIC has responded for the Federal Reserve Board and the Comptroller of the Currency.
- In regards to item number 7 of the August 1 letter, the Comptroller of the Currency is providing data on loans classified due to transfer risk for all insured commercial banks. In addition, the Federal Reserve Board is providing data on classified energy loans and real estate loans for all insured commercial banks as well as data on nonperforming loans and net charge-offs in the real estate, agricultural, and international areas.
- In regards to item number 8 of the August 1 letter, the FDIC is providing aggregate year end brokered deposits data for year end 1983 and 1984 for the Federal Reserve Board and Comptroller of the Currency.

1. Number and total deposits of problem organizations (i.e., organizations rated a composite 4 or 5 under the Uniform Financial Institutions Rating System).

TOTAL NUMBER OF FDIC-INSURED PROBLEM COMMERCIAL BANKS AND THRIFTS AND AGGREGATE TOTAL DEPOSITS BY YEAR

Year End	0 - $300 Million	Over $300 Million	Total Number of Problem Banks and Thrifts	Percent of Total Banks and Thrifts
1984	778	70	848	5.8
1983	591	51	642	4.4
1982	332	37	369	2.5
1981	197	26	223	1.5
1980	206	11	217	1.5
1979	274	13	287	2.0
1978	322	20	342	2.3
1977	348	20	368	2.5
1976	361	18	379	2.6
1975	305*	7*	349	2.4

Year End	Total Deposits of Problem Banks and Thrifts (In Millions)	Percent of Total Deposits	Average Size of Problem Banks and Thrifts (In Millions)
1984	186,109	10.3	219
1983	129,081	7.6	201
1982	57,338	3.7	155
1981	42,564	3.0	191
1980	21,644	1.6	100
1979	20,317	1.7	71
1978	64,142	5.6	188
1977	61,904	5.9	168
1976	59,153	6.3	156
1975	20,443	2.3	59

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*As of September 1975

Source: Examination Reports

1. Continued

ANNUAL DELETIONS FROM PROBLEM BANK LIST

Year	Bank Failures	Banks Removed from the Problem Bank List Due to Improved Condition (Includes Voluntary Mergers)	Total
1984	79	217	296
1983	48	101	149
1982	42	83	125
1981	10	117	127
1980	10	184	194
1979	10	188	198
1978	7	188	195
1977	6	170	176
1976	16	142	158
1975	13	85	98

Source: FDIC

2. Number and total assets of organizations that failed or were absorbed to avert failure.

All Insured Banks
(Size Categories by Total Assets)
(000)

Year	#	Under $300 Million	#	$300 Million - $1 Billion	#	Over $1 Billion	#	Total
*1984	77	2,638,672	2	905,156	0		79	3,543,828
1983	44	2,321,643	2	1,114,502	2	4,047,489	48	7,483,634
1982	33	962,032	5	3,156,389	4	7,700,000	42	11,818,421
1981	7	109,333	1	900,000	2	3,900,000	10	4,909,333
**1980	10	245,874	0		0		10	245,874
1979	10	141,642	0		0		10	141,642
1978	6	279,729	1	712,500	0		7	992,229
1977	6	232,608	0		0		6	232,608
1976	15	627,149	1	412,107	0		16	1,039,256
1975	13	418,574	0		0		13	418,574
1974	3	166,934	0		1	3,655,662	4	3,822,596
1973	5	43,806	0		1	1,265,868	6	1,309,674
1972	1	22,054	0		0		1	22,054
1971	6	196,518	0		0		6	196,518
1970	7	62,107	0		0		7	62,107

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*Excludes Continental Illinois National Bank.
**Excludes First Pennsylvania Bank, N.A.

Source: Examination Reports.

2. (Continued) Number and total assets of organizations that failed or were absorbed to avert failure.

State Nonmember Commercial Banks
(Size Categories by Total Assets)
(000)

Year	#	Under $300 Million	#	$300 Million - $1 Billion	#	Over $1 Billion	#	Total
1984	54	1,946,513	1	391,780	0		55	2,338,293
1983	32	1,326,162	2	1,114,502	0		34	2,440,664
1982	22	320,238	0		0		22	320,238
1981	4	63,957	0		0		4	63,957
1980	9	233,352	0		0		9	233,352
1979	7	72,804	0		0		7	72,804
1978	5	52,929	1	712,500	0		6	765,429
1977	5	226,342	0		0		5	226,342
1976	13	400,035	0		0		13	400,035
1975	10	189,081	0		0		10	189,081
1974	2	150,639	0		0		2	150,639
1973	3	29,207	0		0		3	29,207
1972	1	22,054	0		0		1	22,054
1971	5	195,217	0		0		5	195,217
1970	6	40,691	0		0		6	40,691

Source: Examination Reports.

2. (Continued) Number and total assets of organizations that failed or were absorbed to avert failure.

Mutual Savings Banks
(Size Categories by Total Assets)
(000)

Year	#	Under $300 Million	#	$300 Million - $1 Billion	#	Over $1 Billion	#	Total
1984	0		1	513,376	0		1	513,376
1983	2	401,324	0		1	2,500,000	3	2,901,324
1982	1	55,250	3	2,170,305	4	7,700,000	8	9,925,555
1981	0		1	900,000	2	3,900,000	3	4,800,000

Note: No mutual savings banks failed or were absorbed to avert failure during the 1970-1980 period.

Source: Examination Reports.

2. (Continued) Number and total assets of organizations that failed or were absorbed to avert failure.

National Banks
(Size Categories by Total Assets)
(000)

Year	#	Under $300 Million	#	$300 Million - $1 Billion	#	Over $1 Billion	#	Total
*1984	17	555,054	0		0		17	555,054
1983	8	406,666	0		1	1,547,489	9	1,954,155
1982	8	318,431	2	986,084	0		10	1,304,515
1981	1	10,566	0		0		1	10,566
**1980	1	12,522	0		0		1	12,522
1979	3	68,838	0		0		3	68,838
1978	1	226,800	0		0		1	226,800
1977	1	6,266	0		0		1	6,266
1976	1	2,612	1	412,107	0		2	414,719
1975	2	155,139	0		0		2	155,139
1974	0		0		1	3,555,662	1	3,655,662
1973	2	14,599	0		1	1,265,868	3	1,280,467
1972	0		0		0		0	
1971	1	1,301	0		0		1	1,301
1970	1	21,416	0		0		1	21,416

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*Excludes Continental Illinois National Bank.
**Excludes First Pennsylvania Bank, N.A.

Source: Examination Reports.

2. (Continued) Number and total assets of organizations that failed or were absorbed to avert failure.

State Member Commercial Banks
(Size Categories by Total Assets)
(000)

Year	#	Under $300 Million	#	$300 Million - $1 Billion	#	Over $1 Billion	#	Total
1984	6	137,105	0		0		6	137,105
1983	2	187,491	0		0		2	187,491
1982	2	268,113	0		0		2	268,113
1981	2	34,810	0		0		2	34,810
1980	0		0		0		0	
1979	0		0		0		0	
1978	0		0		0		0	
1977	0		0		0		0	
1976	1	224,502	0		0		1	224,502
1975	1	74,354	0		0		1	74,354
1974	1	16,295	0		0		1	16,295
1973	0		0		0		0	
1972	0		0		0		0	
1971	0		0		0		0	
1970	0		0		0		0	

Source: Examination Reports.

3(a). Primary capital as a percent of total assets (data from Call Reports)

State Nonmember Commercial Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total	All Insured Commercial Banks
1984	8.74%	7.48%	6.46%	8.10%	6.89%
1983	8.70	7.25	6.17	8.02	6.66
1982	8.78	7.30	6.10	8.12	6.48
1981	8.74	7.21	5.94	8.09	6.39
1980	8.71	7.26	5.77	8.08	6.34
1979	8.53	6.94	5.82	7.98	6.29
1978	8.32	6.99	5.78	7.87	5.79
1977	8.20	7.05	6.43	7.92	6.17
1976	8.33	7.34	6.57	8.10	6.65
1975	8.26	7.46	6.76	8.07	6.42
1974	8.26	7.38	6.96	8.09	6.21
1973	7.96	7.12	6.66	7.81	N.A.
1972	7.88	7.15	5.81	7.75	N.A.
1971	8.17	7.41	6.06	8.06	N.A.
1970	8.46	7.57	6.14	8.36	N.A.

Definition: Aggregate year-end net worth plus allowance for possible loan losses divided by aggregate year-end total assets for all banks in each size category.

Source: Call Reports.

3(a). Continued

Mutual Savings Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	6.71%	6.17%	4.43%	5.30%
1983	6.49	5.87	4.20	4.92
1982	6.44	5.90	4.02	4.89
1961	6.82	6.15	4.76	5.45
1980	7.35	6.88	5.87	6.36
1979	7.54	7.10	6.47	6.81
1978	7.28	6.72	6.21	6.53
1977	6.98	6.73	6.00	6.40
1976	6.93	6.72	6.05	6.42
1975	7.04	6.80	6.40	6.66
1974	7.32	7.05	6.72	6.96
1973	7.19	6.93	6.69	6.88
1972	7.17	6.78	6.48	6.74
1971	7.35	6.89	6.72	6.94
1970	N.A	N.A	N.A	7.35

Definition: Aggregate year-end net worth plus allowance for possible loan losses divided by aggregate year-end total assets for all banks in each size category.

Source: Call Reports.

3(b). Primary capital as a percent of total assets (data from Examination Reports)

State Nonmember Commercial Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	8.92%	7.66%	6.53%	8.26%
1983	9.02	7.58	6.39	8.33
1982	9.09	7.94	6.63	8.52
1981	9.23	8.06	7.00	8.72
1980	9.09	8.10	7.09	8.67
1979	8.92	7.96	7.25	8.59
1978	8.78	7.96	7.36	8.52
1977	8.82	7.96	7.83	8.63
1976	8.84	8.40	7.83	8.72
1975	8.89	8.28	8.07	8.77
1974	8.75	7.95	7.96	8.61
1973	8.61	8.14	7.97	8.53
1972	8.63	8.46	6.76	8.58
1971	8.93	8.48	7.54	8.86
1970	9.32	8.52	7.89	9.24

Definition: Aggregate equity capital plus allowance for possible loan losses divided by aggregate total assets for all banks in each size category. Figures are aggregated from the latest available examination as of year-end for all banks in each size category. Due to the intermittent nature of exam scheduling the above data do not cover uniform periods and therefore may differ from the data derived from year-end Call Reports.

Source: Examination Reports.

3(b). Continued

Mutual Savings Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	6.52%	6.32%	4.55%	5.37%
1983	6.56	5.79	4.32	4.99
1982	6.66	6.08	3.80	4.84
1981	7.20	6.75	5.53	6.13
1980	7.51	7.04	6.21	6.64
1979	7.51	6.95	6.26	6.65
1978	7.31	6.65	6.20	6.50

Note: Data not available before 1978.

Definition: Aggregate net worth plus allowance for possible loan losses divided by aggregate total assets for all banks in each size category. Figures are aggregated from the latest available examination as of year-end for all banks in each size category. Due to the intermittent nature of exam scheduling the above data do not cover uniform periods and therefore may differ from the data derived from year-end Call Reports.

Source: Examination Reports.

4. Primary capital less 20% of substandard, 50% of doubtful and 100% of loss as a percent of total assets.

State Nonmember Commercial Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	7.96%	6.87%	5.92%	7.39%
1983	8.11	7.49	5.49	7.42
1982	8.30	7.10	5.89	7.74
1981	8.65	7.43	6.45	8.14
1980	8.57	7.51	6.56	8.14
1979	8.44	7.43	6.61	8.09
1978	8.22	7.16	6.65	7.92
1977	8.14	6.81	6.80	7.86
1976	8.05	6.96	6.69	7.83
1975	8.07	6.88	7.19	7.88
1974	8.14	7.04	7.30	7.96
1973	8.13	7.49	7.51	8.03
1972	8.13	7.76	6.11	8.05
1971	8.36	7.57	7.19	8.26
1970	8.74	7.58	7.59	8.63

Definition: Aggregate equity capital plus allowance for possible loan losses less classified assets divided by aggregate total assets for all banks in each size category. Figures are aggregated from the latest available examination as of year-end for all banks in each size category. Due to the intermittent nature of exam scheduling the above data do not cover uniform periods and therefore may differ from the data derived from year-end Call Reports.

Source: Examination Reports.

4. Continued

Mutual Savings Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million- $1 Billion	Over $1 Billion	Total
1984	6.04%	5.70	3.96%	4.78%
1983	6.13	5.27	3.63	4.38
1982	6.02	5.40	2.96	4.07
1981	6.59	6.03	4.58	5.30
1980	6.84	6.31	5.19	5.75
1979	6.93	6.22	5.32	5.82
1978	6.67	5.76	5.12	5.55

Note: Data not available before 1978

Definition: Aggregate net worth plus allowcnce for possible loan losses less classified assets divided by aggregate total assets for all banks in each size category. Figures are aggregated from the latest available examination as of year-end for all banks in each size category. Due to the intermittent nature of exam scheduling the above data do not cover uniform periods and therefore may differ from the data derived from year-end Call Reports.

Source: Examination Reports.

5. Primary capital less classified assets (as defined in no. 4) as a percent of total assets plus standby letters of credit.

State Nonmember Commercial Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	7.91%	6.75%	5.73%	7.30%
1983	8.06	6.56	5.36	7.34
1982	8.25	7.00	5.78	7.66
1981	8.59	7.34	6.34	8.07
1980	8.53	7.44	6.47	8.09
1979	8.41	7.37	6.53	8.04
1978	8.19	7.11	6.58	7.88
1977	8.12	6.77	6.71	7.83
1976	7.99	6.93	6.63	7.77
1975	8.07	6.86	7.18	7.87
1974	8.14	7.02	7.28	7.95

Note: Data for commercial banks not available before 1974. Data on standby letters of credit for Mutual Savings Banks not available because data is not collected on Call Reports.

Definition: Aggregate equity capital plus allowance for possible loan losses less classified assets divided by aggregate total assets plus standby letters of credit for all banks in each size category. Figures are aggregated from the latest available examination as of year-end for all banks in each size category except standby letters of credit are aggregated from year-end Call Reports. Due to the intermittent nature of exam scheduling the above data do not cover uniform periods and therefore may differ from the data derived from year-end Call Reports.

Source: Examination reports, except data for standby letters of credit are from the Call Reports.

6(a). Classified assets (as defined in no. 4) as a percent of total assets.

State Nonmember Commercial Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	0.95%	0.79%	0.61%	0.86%
1983	0.91	0.92	0.90	0.91
1982	0.78	0.84	0.73	0.79
1981	0.58	0.63	0.55	0.58
1980	0.51	0.59	0.53	0.53
1979	0.48	0.54	0.64	0.51
1978	0.56	0.79	0.71	0.61
1977	0.68	1.15	1.04	0.77
1976	0.80	1.44	1.14	0.89
1975	0.82	1.40	0.89	0.89
1974	0.61	0.92	0.66	0.65
1973	0.48	0.65	0.46	0.50
1972	0.50	0.70	0.65	0.53
1971	0.56	0.91	0.35	0.60

Note: Data not available for 1970.

Definition: Aggregate classified assets (as defined in no. 4) divided by aggregate total assets for all banks in each size category. Figures are aggregated from the latest available examination as of year-end for all banks in each size category. Due to the intermittent nature of exam scheduling the above data do not cover uniform periods and therefore may differ from the data derived from year-end Call Reports.

Source: Examination Reports.

6(a). Continued

Mutual Savings Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	0.48%	0.62%	0.60%	0.58%
1983	0.43	0.51	0.69	0.61
1982	0.63	0.69	0.84	0.77
1981	0.61	0.72	0.96	0.84
1980	0.67	0.73	1.02	0.89
1979	0.58	0.73	0.95	0.83
1978	0.64	0.89	1.08	0.95
1977	0.71	1.11	1.25	1.11
1976	0.75	1.24	1.43	1.24
1975	1.00	1.43	1.42	1.34
1974	0.82	1.16	1.45	1.22
1973	0.32	0.50	0.33	0.39

Note: Data not available before 1973.

Definition: Aggregate classified assets (as defined in no. 4) divided by aggregate total assets for all banks in each size category. Figures are aggregated from the latest available examination as of year-end for all banks in each size category. Due to the intermittent nature of exam scheduling the above data do not cover uniform periods and therefore may differ from the data derived from year-end Call Reports.

Source: Examination Reports.

6(b). Nonperforming assets as a percent of total assets.

State Nonmember Commercial Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	1.86%	1.65%	1.60%	1.81%
1983	1.87	2.02	1.76	1.82
1982	1.74	2.14	2.22	1.88

All Insured Commercial Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	1.79%	1.54%	1.83%	1.78%
1983	1.66	1.69	2.30	2.03
1982	1.65	1.85	2.40	2.11

Note: Data not available before 1982.

Definition: Nonperforming assets are loans and leases past due 90 days or more and still accruing income, nonaccrual loans, renegotiated troubled debt and other real estate owned. Aggregate year-end nonperforming assets divided by aggregate year-end total assets for all banks in each size category.

Source: Call Reports.

8(a). Purchased funds as a percent of total assets.

State Nonmember Commercial Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	13.66%	22.34%	33.87%	18.97%
1983	12.90	22.25	34.38	18.21
1982	14.93	25.68	39.41	20.46
1981	15.41	28.19	40.66	21.14
1980	13.78	26.65	36.23	18.84
1979	13.00	25.12	33.14	17.10
1978	12.12	22.63	30.58	15.49
1977	10.46	17.16	23.45	12.35
1976	10.08	17.79	23.40	11.91

Note: Data not available before 1976.

Definition: Aggregate year-end volatile liabilities divided by aggregate year-end total assets. Volatile liabilities are time deposits of $100,000 or more plus federal funds purchased and securities sold under agreements to repurchase plus interest-bearing demand notes issued to the U.S. Treasury and other liabilities for borrowed money plus deposits in foreign offices.

Source: Call Reports.

8(b). Brokered deposits as a percent of total deposits.

State Nonmember Commercial Banks

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	0.21	0.23	4.21	0.90
1983	0.28	0.30	5.19	1.07

Mutual Savings Banks

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	0.09	0.18	1.64	0.97
1983	0.17	0.00	0.77	0.51

National Banks

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	0.12	0.21	2.91	1.95
1983	0.19	0.28	2.60	1.72

State Member Banks

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	0.11	0.11	1.26	0.93
1983	0.16	0.00	1.42	1.06

All Insured Commercial Banks

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	0.16	0.20	2.64	1.45
1983	0.23	0.21	2.39	1.36

Note: Data not available before 1983.

Definition: Aggregate year-end brokered deposits (i.e., deposits received from brokers or dealers for the account of others either directly or ultimately) divided by aggregate total year-end deposits for all banks in each size category.

Source: Call Reports.

9(a) Net income as a percent of total assets.

State Nonmember Commercial Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total	All Insured Commercial Banks
1984	0.83%	0.80%	0.66%	0.79%	0.63%
1983	0.86	0.70	0.61	0.79	0.64
1982	0.97	0.72	0.62	0.88	0.68
1981	1.06	0.79	0.57	0.94	0.73
1980	1.11	0.91	0.64	1.02	0.75
1979	1.09	0.87	0.70	1.01	0.76
1978	0.98	0.82	0.66	0.92	0.71
1977	0.89	0.62	0.66	0.84	0.66
1976	0.85	0.69	0.67	0.82	0.66
1975	0.82	0.65	0.64	0.79	0.66
1974	0.91	0.82	0.66	0.89	0.68
1973	0.92	0.86	0.57	0.90	0.78
1972	0.84	0.83	0.57	0.84	0.77
1971	0.89	0.89	0.42	0.88	0.82
1970	0.94	0.94	0.50	0.94	0.84

Definition: Aggregate net income divided by aggregate year-end total assets for all banks in each size category.

Source: Call Reports.

9(a) Net income as a percent of total assets.

Mutual Savings Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total
1984	0.48%	0.30%	-0.18%	0.06%
1983	0.39	0.15	-0.30	-0.10
1982	-0.26	-0.44	-1.10	-0.80
1981	-0.32	-0.65	-1.23	-0.93
1980	0.24	-0.02	-0.35	-0.17
1979	0.64	0.44	0.38	0.44
1978	0.74	0.59	0.50	0.57
1977	0.70	0.53	0.44	0.52
1976	0.61	0.45	0.33	0.42
1975	0.51	0.34	0.27	0.34
1974	0.54	0.36	0.22	0.33
1973	0.63	0.48	0.49	0.51
1972	0.63	0.56	0.49	0.55
1971	0.56	0.45	0.36	0.44
1970	N/A	N/A	N/A	0.24

Definition: Aggregate net income divided by aggregate year-end total assets for all banks in each size category.

Source: Call Reports.

9(b) Net income as a percent of total equity.

State Nonmember Commercial Banks
(Size Categories by Total Assets)

Year	Under $300 Million	$300 Million-$1 Billion	Over $1 Billion	Total	All Insured Commercial Banks
1984	10.20%	11.81%	11.39%	10.61%	10.21%
1983	10.61	10.56	11.00	10.66	10.70
1982	11.85	10.72	11.25	11.63	11.63
1981	12.84	11.94	10.60	12.48	12.51
1980	13.61	13.63	12.16	13.47	13.02
1979	13.64	13.71	13.29	13.62	13.20
1978	12.55	12.81	12.43	12.58	13.57
1977	11.64	9.58	11.44	11.43	11.73
1976	10.87	10.00	11.06	10.82	10.85
1975	11.01	9.92	10.74	10.88	11.29
1974	12.20	12.70	10.77	12.20	12.00
1973	12.85	13.81	9.59	12.85	12.25
1972	11.85	13.22	10.57	12.01	11.71
1971	12.08	13.73	7.51	12.22	11.91
1970	12.42	14.51	8.20	12.55	11.95

Definition: Aggregate net income divided by aggregate year-end total equity for all banks in each size category.

Source: Call Reports.

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NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

September 5, 1985

Honorable Fernand J. St Germain
Chairman
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
Committee on Banking, Finance and
Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman St Germain:

Thank you for your letter of August 1.

Pursuant to that letter and to subsequent discussions with your staff, the National Credit Union Administration is pleased to provide the Subcommittee with the attached data on credit union operations.

Please let us know if we may be of further assistance.

Sincerely,

P.A. Mack, Jr

P. A. MACK, JR.
Vice Chairman

PAM:dl

Enclosure

ITEM #1

NUMBER AND TOTAL DEPOSITS (SHARES) OF "PROBLEM" ORGANIZATIONS

Year	Number	Deposits (Millions)
6/30/85	732	$3,821
1984	872	$4,071
1983	1,124	$4,652
1982	1,192	$4,590
1981	1,174	$2,980
1980	1,018	$2,400
1979	1,020	$2,300
1978	825	$1,450
1977	660	531
1976	830	570

"Problem" organizations are defined as codes 4 and 5 federal credit unions and federally insured state-chartered credit unions

The above data is reported as of fiscal year-end - September 30.

NOTE: All data throughout the report is combined for federally chartered credit unions and for federally insured state-chartered credit unions

ITEM #2

NUMBER AND TOTAL DEPOSITS (SHARES) OF ORGANIZATIONS FAILED OR ABSORBED TO AVERT FAILURE

Year	Liquidations		Assisted Mergers/ Purchase & Assumptions	
	Number	Amount of Shares (Millions)	Number	Amount of Shares (Millions)
6/30/85	26	$11.7	54	$41.8
1984	38	$34.8	100	$190.2
1983	50	$10.0	212	N/A
1982	160	$39.9	182	N/A
1981	251	$78.6	100	N/A
1980	239	$60.0	63	N/A
1979	169	$19.0		
1978	168	$14.2		
1977	142	$12.7		
1976	128	$7.5		
1975	153	$5.5		
1974	100	$2.8		
1973	50	$1.4		
1972	4	$0.002		
1971	0	$0		

Numbers of assisted mergers and purchase and assumptions were not identified separately from unassisted mergers until 1980

The above data is reported as of fiscal year-end - September 30. The data for June 30, 1985, is for a 9-month period.

ITEM #3

PRIMARY CAPITAL AS A PERCENTAGE OF TOTAL ASSETS

Year	Percentage
6/30/85	6.82
1984	7.07
1983	6.86
1982	7.24
1981	6.98
1980	6.40
1979	6.66
1978	6.25
1977	6.05
1976	6.30
1975	6.56
1974	7.00
1973	8.96
1972	9.23
1971	9.06

As nonprofit cooperatives, credit unions do not have "capital." However, for purposes of this report and in order to be somewhat consistent with the reporting of the other agencies, capital in credit unions is defined as all reserves and retained earnings and does not include shares.

ITEM #4

PRIMARY CAPITAL LESS CLASSIFIED ASSETS AS A PERCENTAGE OF TOTAL ASSETS

Year	Percentage
6/30/85	6.46
1984	6.69
1983	6.39
1982	6.66
1981	6.40
1980	5.76
1979	6.06
1978	5.78

See the definition of primary capital under item 3. Classified assets are defined as 50 percent of loans 6 to 12 months delinquent and 75 percent of loans in excess of 12 months delinquent. Loan delinquency by age category is not available prior to 1978.

ITEM #5

PRIMARY CAPITAL LESS CLASSIFIED ASSETS AS A PERCENTAGE OF TOTAL ASSETS, INCLUDING STANDBY LETTERS OF CREDIT AND OTHER OFF-BALANCE SHEET ITEMS

The figures for this item would be the same as item #4. Credit unions do not have standby letters of credit or other significant off-balance sheet items.

ITEM #6

CLASSIFIED ASSETS AND NONPERFORMING ASSETS AS A PERCENTAGE OF TOTAL ASSETS

Year	Percentage
6/30/85	.58
1984	.61
1983	.74
1982	.93
1981	.91
1980	1.03
1979	.96
1978	.77

For purposes of this report, nonperforming assets are considered to be all loans in excess of 6 months delinquent.

ITEM #7

CLASSIFIED AND NONPERFORMING ENERGY LOANS, AGRICULTURAL LOANS, INTERNATIONAL LOANS, AND REAL ESTATE DEVELOPMENT LOANS AND INVESTMENTS, EACH AS A PERCENTAGE OF PRIMARY CAPITAL

Credit unions are consumer oriented and their lending activities are concentrated primarily in consumer-type loans. There are no international loans or real estate development investments. We are not aware of any significant amount of energy loans or real estate development loans. We are beginning to experience some problems with credit unions in the farm belt whose fields of membership are dedicated primarily to the farm community.

Agriculture loans and real estate development loans are not separately identified on our call reports, but we will begin obtaining this information during the next call report period.

ITEM #8

PURCHASED FUNDS AND BROKERED DEPOSITS, EACH AS A PERCENTAGE OF TOTAL ASSETS

Year	Percentage
6/30/85	.4
1984	1.0
1983	.8
1982	.9
1981	1.9
1980	2.3
1979	4.8
1978	6.2
1977	5.3
1976	4.3
1975	3.9
1974	4.1
1973	3.7
1972	2.3
1971	2.3

The percentages listed above represent borrowed funds. There have been some isolated incidents of brokered funds received by credit unions, but this does not seem to be a widespread occurrence. Brokered funds activity was reported by credit unions for the first time on the December 1984 call reports, but the information was subsequently found to be inaccurate - overstated. The data reported would have resulted in a figure of less than .1 percent.

ITEM #9

NET INCOME AS A PERCENTAGE OF EQUITY CAPITAL AND NET INCOME AS A PERCENTAGE OF ASSETS

Year	Net Income to Capital	Net Income to Assets
6/30/85	16.32*	1.11*
1984	17.28	1.22
1983	13.30	.91
1982	14.12	1.02
1981	14.89	1.04
1980	8.02	.51
1979	13.04	.87
1978	17.61	1.10
1977	16.79	1.02
1976	17.60	1.11
1975	15.71	1.03
1974	17.64	1.23
1973	12.93	1.16
1972	13.03	1.20
1971	12.63	1.22

Net income is before reserve transfers.

The same definition of capital is applied here as in item #3.

*Annualized

ITEM #10

SUPPLEMENTAL INFORMATION

NUMBER AND TOTAL DEPOSITS (SHARES) OF PROBLEM CREDIT UNIONS AS A PERCENTAGE OF TOTAL INSURED CREDIT UNIONS

Year	Number as % of Total	Deposits as % of Total
6/30/85	4.9	4.0
1984	5.7	4.5
1983	7.1	5.8
1982	7.2	6.7
1981	6.9	5.2
1980	5.9	4.4
1979	5.8	4.8
1978	4.8	3.3
1977	4.0	1.4
1976	5.1	1.9

See item #1 for definition of problem credit unions.

ITEM #10

SUPPLEMENTAL INFORMATION

GENERAL DATA

Year	Number of Credit Unions	Number of Members	Assets (Millions)	Shares (Millions)
6/30/85	14,916	43,940,144	$106,785	$96,703
1984	15,193	43,356,240	$92,846	$84,254
1983	15,877	41,076,615	$81,961	$74,186
1982	16,435	39,298,832	$69,572	$62,976
1981	16,963	38,413,265	$64,490	$57,796
1980	17,350	36,856,813	$60,962	$54,732
1979	17,507	37,008,329	$54,928	$47,703
1978	17,121	34,739,247	$51,417	$44,119
1977	16,632	29,421,785	$43,451	$37,333
1976	16,276	26,297,210	$35,095	$30,354
1975	15,777	23,747,455	$28,814	$24,973
1974	15,146	21,068,652	$22,754	$19,562
1973	14,344	18,496,398	$18,902	$16,332
1972	14,023	16,615,748	$15,811	$13,843
1971	13,510	14,826,447	$12,506	$10,891

ITEM #10

SUPPLEMENTAL INFORMATION

ANNUAL GROWTH RATES FOR ASSETS AND SHARES

Year	Assets	Shares
6/30/85	30.0% *	29.6% *
1984	13.3%	13.6%
1983	17.8%	17.8%
1982	7.9%	9.0%
1981	5.8%	5.6%
1980	11.0%	14.7%
1979	6.8%	8.1%
1978	18.3%	18.2%
1977	23.8%	23.0%
1976	21.8%	21.5%
1975	26.6%	27.7%
1974	20.4%	19.8%
1973	19.5%	18.0%
1972	26.4%	27.1%

These figures are based on aggregte amounts in all federally insured credit unions and may be impacted by credit unions entering or leaving the federal share insurance system.

*Annualized

ITEM #10

SUPPLEMENTAL INFORMATION

NUMBER OF MAJOR PROBLEM CASE CREDIT UNIONS

Year	Number
6/30/85	50
1984	72
1983	113
1982	124
1981	114
1980	59
1979	30
1978	12
1977	9
1976	10
1975	5
1974	4
1973	20
1972	0
1971	0

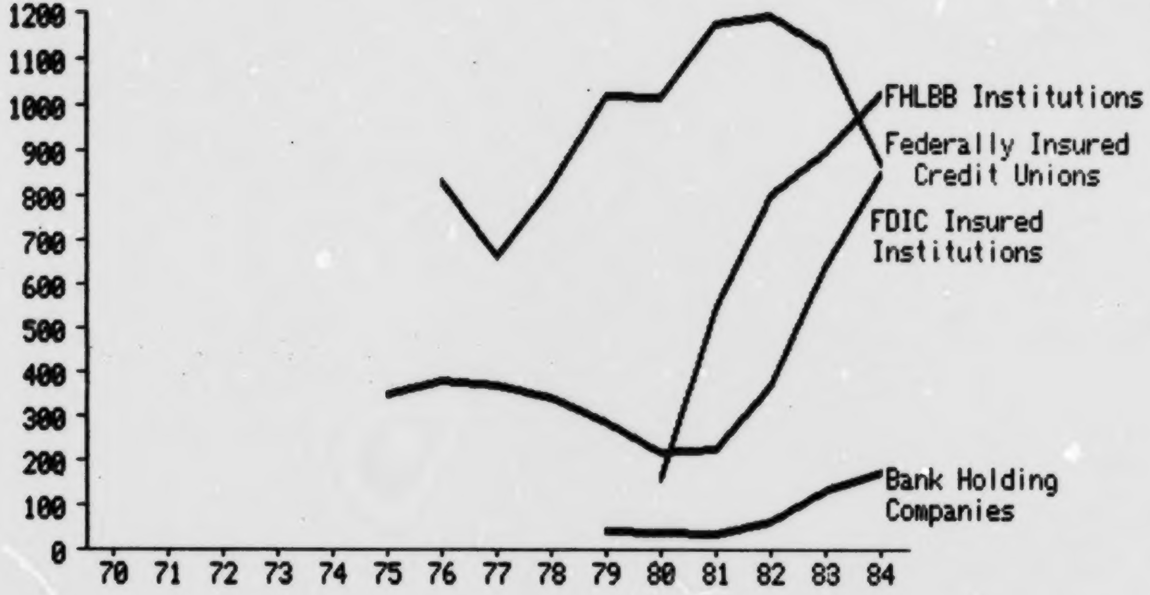
These figures represent the number of operating credit unions with outstanding assistance from the National Credit Union Share Insurance Fund. These are the most severe problem cases and represent the highest degree of risk to the Insurance Fund.

DEPOSITORY INSTITUTIONS
STATISTICAL INFORMATION

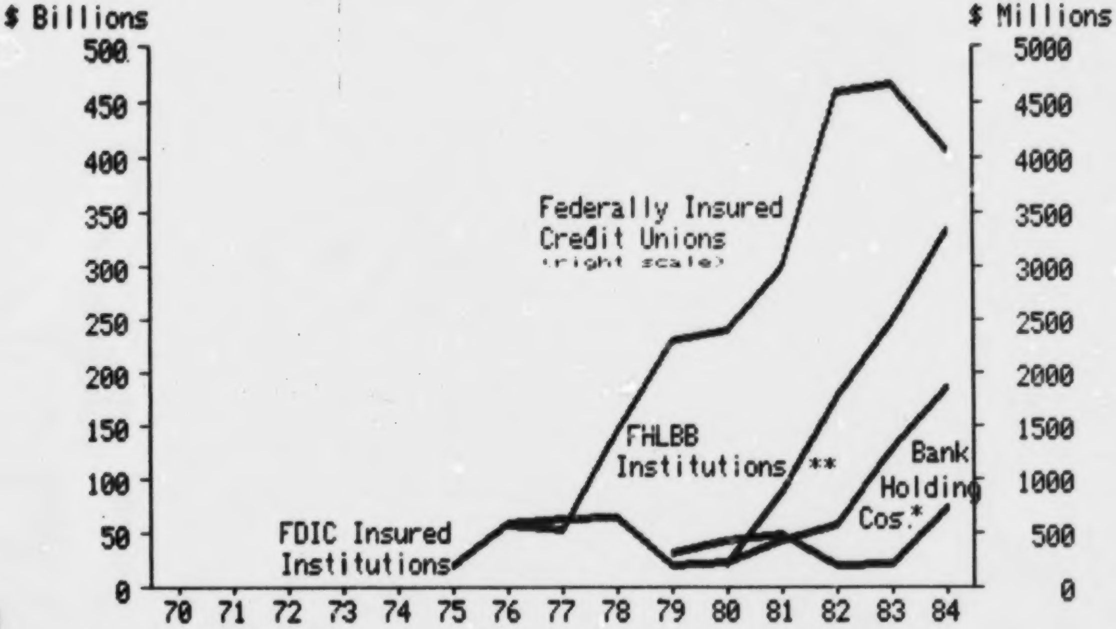
Prepared For the Use of
The Members of
The Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
House Committee on Banking, Finance and Urban Affairs
by the
Subcommittee Staff
with the assistance of
Dr. William Jackson
Congressional Research Service

September 10, 1985

Problem Organizations, Number



Problem Organizations, Total Deposits



* Asset size

** Estimated

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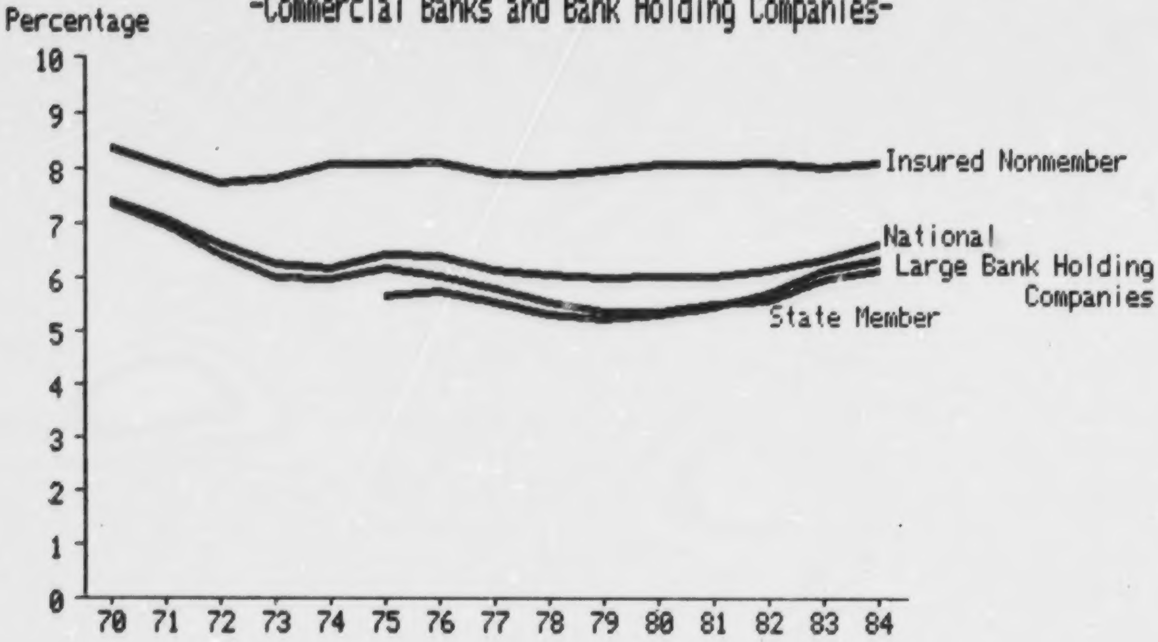
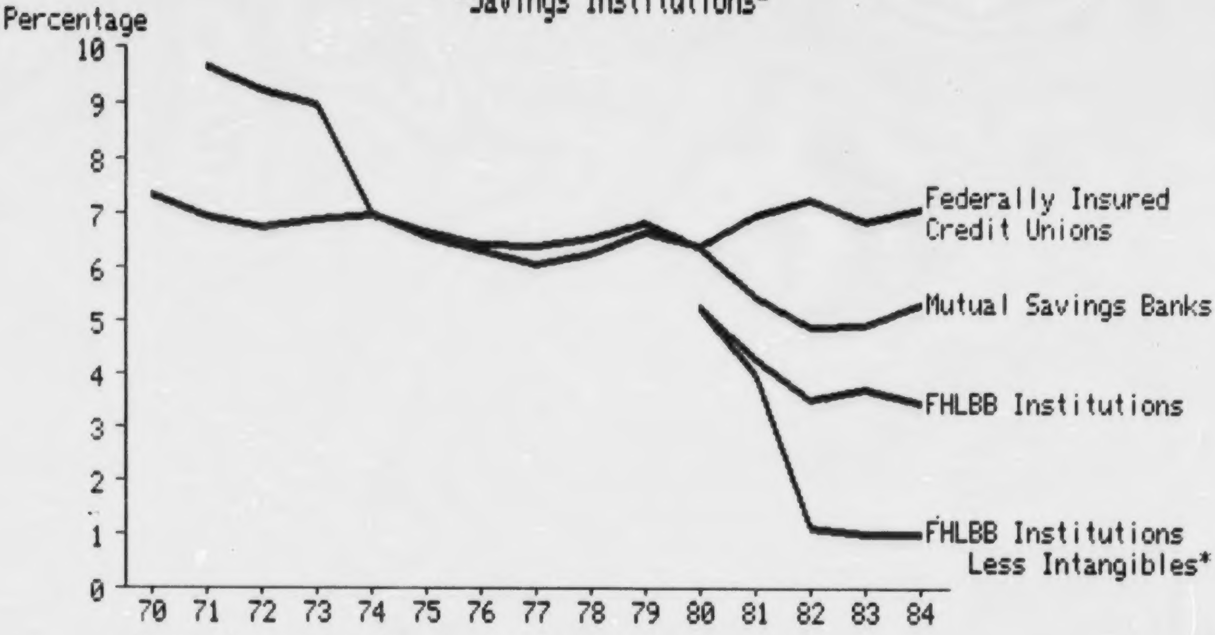
Equity and Loan Loss Reserves As A Percentage of Total Assets
-Commercial Banks and Bank Holding Companies-

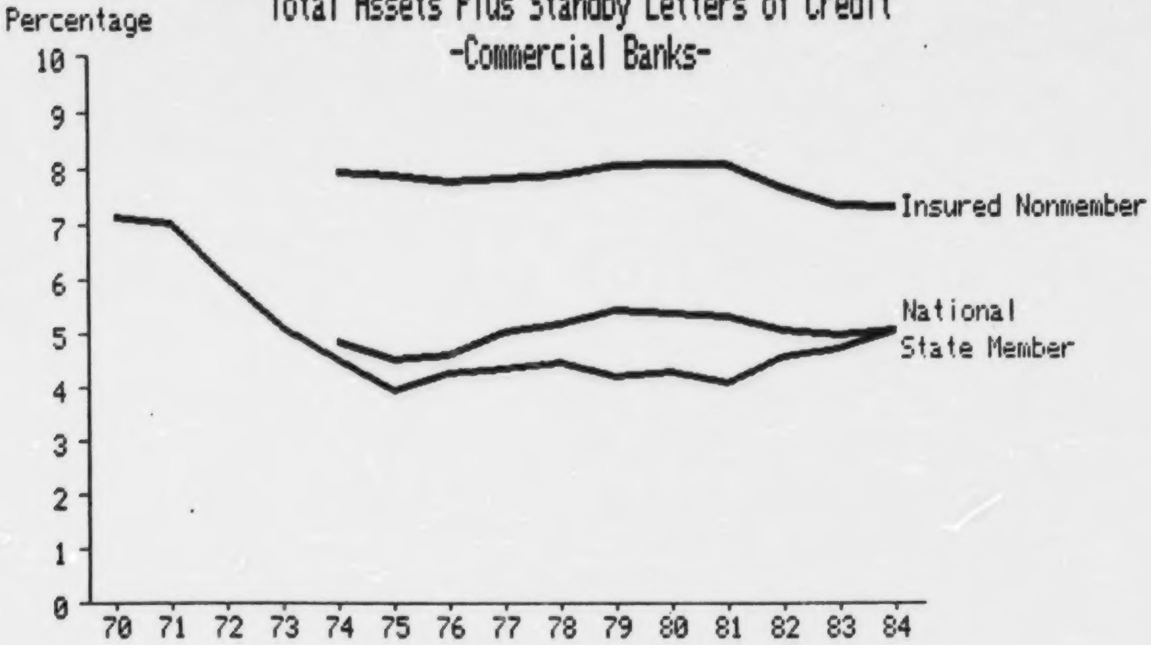


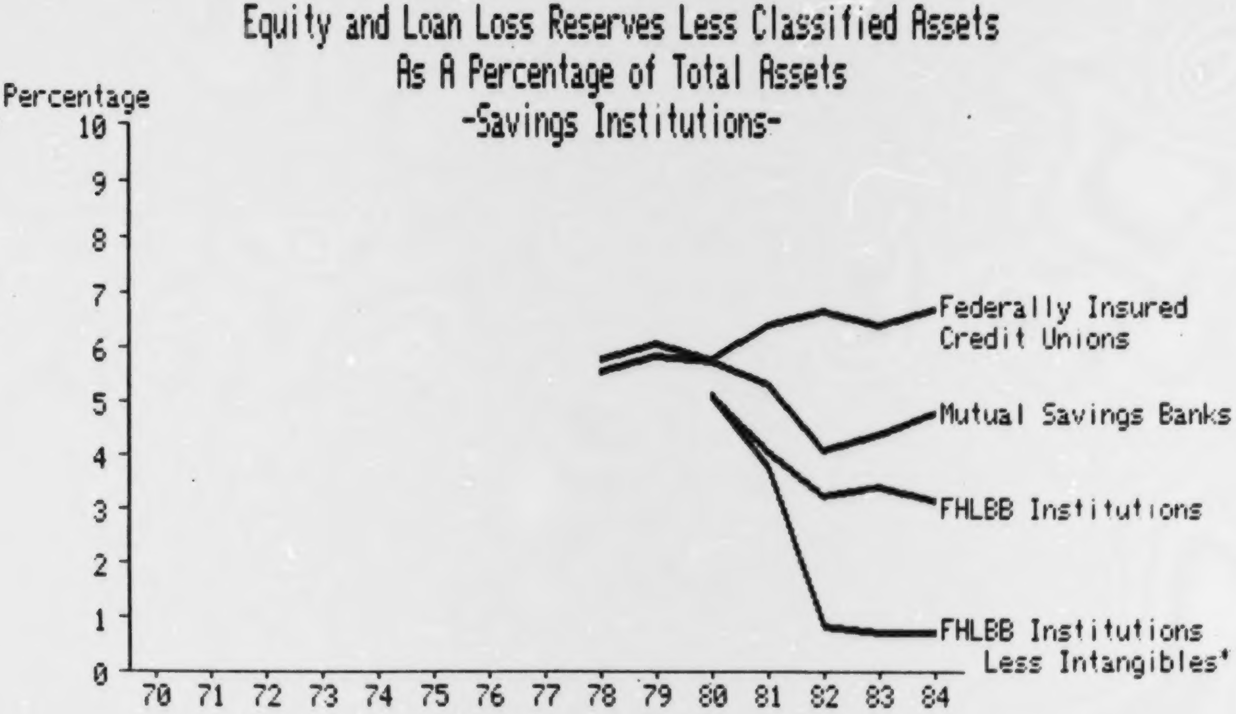
Equity and Loan Loss Reserves As A Percentage of Total Assets
-Savings Institutions-



*excludes goodwill and other intangibles

Equity and Reserves Less Classified Assets As A Percentage of Total Assets Plus Standby Letters of Credit
-Commercial Banks-

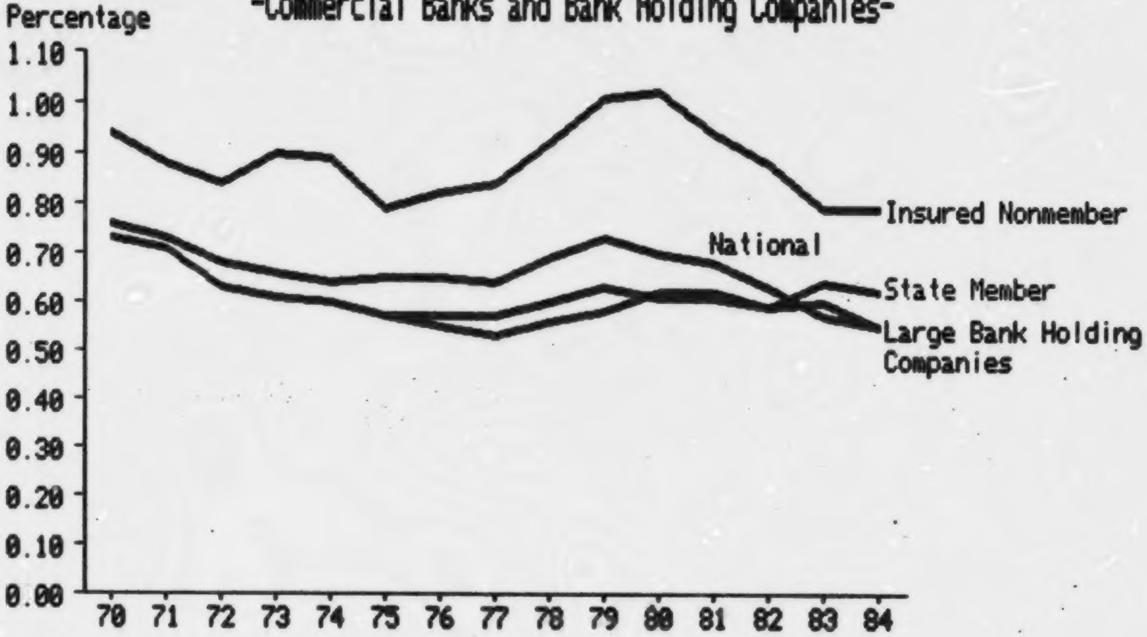




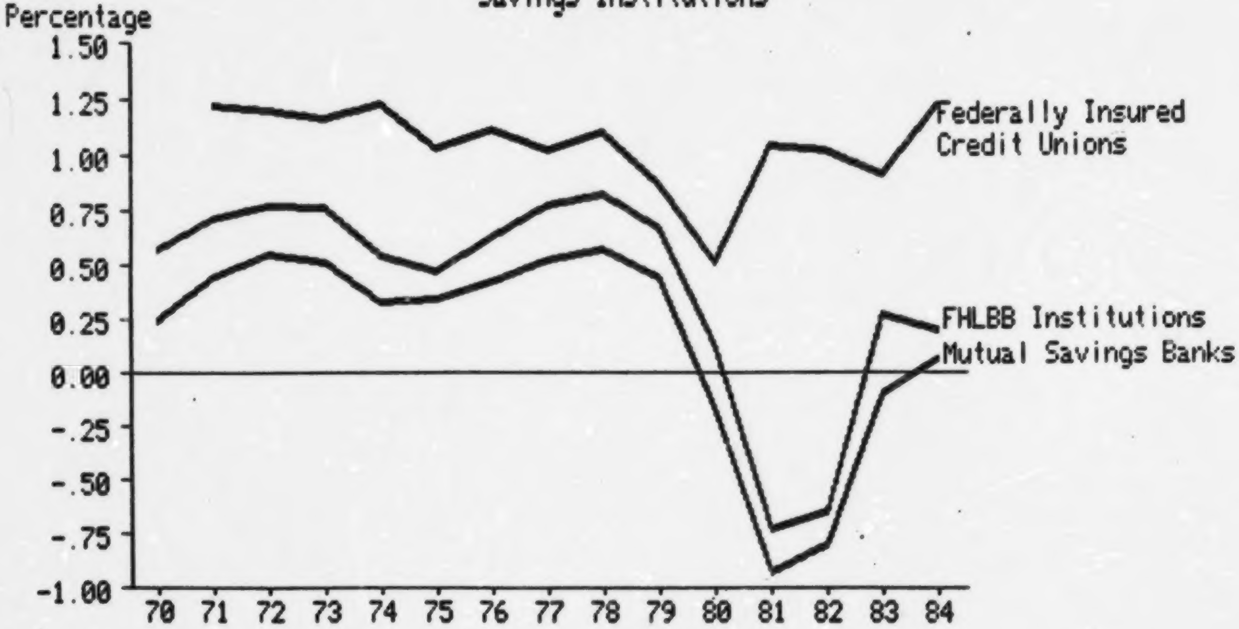
Equity and Loan Loss Reserves Less Classified Assets
As A Percentage of Total Assets
-Savings Institutions-

*excludes goodwill and other intangibles

Net Income As A Percentage of Total Assets
-Commercial Banks and Bank Holding Companies-



Net Income As A Percentage of Total Assets
-Savings Institutions-



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FINANCIAL CONDITION OF THE BANK AND THRIFT INDUSTRIES

THURSDAY, SEPTEMBER 12, 1985

House of Representatives,
Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the subcommittee) presiding.

Present: Chairman St Germain; Representatives Annunzio, Hubbard, Barnard, Oakar, Vento, Cooper, Wylie, McKinney, Wortley, Bereuter, and Roth.

Chairman **St Germain**. The subcommittee will come to order. Today we continue our exploration of the matters bearing on the general question of Federal Deposit Insurance reform. In yesterday's hearings, the subcommittee heard valuable testimony on the financial conditions of federally insured deposit institutions. Today, the subject is the financial condition of the Federal insuring funds, themselves. The testimony we will hear will be an essential element in our understanding of the general deposit insurance situation.

Our witnesses this morning are Stanley Poling, Director, Division of Accounting and Corporate Services, Federal Deposit Insurance Corporation; Peter Stearns, Director, Federal Savings and Loan Insurance Corporation; D. Michael Riley, Director, NCUA Office of Programs, National Credit Union Share Insurance Fund. Mr. Riley, does that mean at the top level of NCUA, you save money by having very few people in top management? Is that it?

Mr. **Riley**. We hope so.

Chairman **St Germain**. And Frederick D. Wolf, Director, Accounting and Financial Management Division, General Accounting Office.

Gentlemen, we will put all of your statements in the record, without objection, and you may now proceed.

Mr. Poling.

STATEMENT OF STANLEY J. POLING, DIRECTOR, DIVISION OF ACCOUNTING AND CORPORATE SERVICES, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. **Poling**. Mr. Chairman, members of the subcommittee, we are pleased to have this opportunity to provide testimony on the financial resources and condition of the FDIC as the subcommittee continues its evaluation of the need for modifications to our system of Federal Deposit Insurance.

As you are aware, the FDIC has over the past 5 years dealt with a post-World War II record number of bank failures throughout the United States. We have responded to 11 bank failures in 1981, 42 in 1982, 48 in 1983, 79 in 1984, and 78 so far in 1985. This period has been difficult for the Corporation and its employees, and we see no letup in the immediate future.

Although failures since 1981 involved over $30 billion in bank assets, exclusive of Continental Illinois, the resources of the FDIC have been strengthened rather than diminished over the period.

The deposit insurance fund, which is defined as the FDIC's net worth, has increased from $11.1 billion at the beginning of 1981 to its current level of $18.8 billion, more than a 70-percent growth.

Moreover, the fund as a percentage of insured deposits during this period increased from 1.21 percent to approximately 1.26 percent, continuing a trend started in the mid-1970's.

The ability of the insurance fund to grow during a period of frequent bank failures is a tribute to the inherent strength of the Federal Deposit Insurance System.

The growth of the fund has been achieved through basically three areas: One, a broad assessment base and system that appears actuarily sound in terms of the volume of failures in the insured system; two, a large and growing investment portfolio of U.S. Treasury securities; and, three, a range of flexibility which allows the FDIC to respond to failing and failed bank situations in ways which are designed to minimize insurance losses.

We submit that the FDIC has functioned exactly as it was designed in 1933; a self-help safety net supported by a broad-based industry's insurance premiums. With a current income stream in excess of $3 billion annually, the FDIC does not use a single dollar of taxpayer funds. We at the FDIC are fully confident of the ability to maintain this tradition.

In response to the specific areas requested in the invitation to this hearing, we have presented in an appendix summary financial statements of condition and income of the FDIC for the last 5 years.

We also have provided a financial statement as of July 31, 1985. The statements present the major asset, liability, revenue and expense components of our financial position. Further and more detailed presentations are contained in our annual reports, which are available to the subcommittee.

Review of our current financial statements quickly reveals the financial resources available for the Corporation's insurance responsibilities. The major components can be aggregated as the $18.8 billion deposit insurance fund, annual gross income—largely from investments and insurance premiums—now in excess of $3.0 billion, and additionally, the Corporation's statutory authority—never used—to borrow up to $3 billion from the U.S. Treasury.

The bulk of the $18.8 billion deposit insurance fund consists of $15.6 billion invested by law in U.S. Treasury securities. That portfolio is highly liquid, with an average maturity of approximately 2 years and 1 month.

The portfolio presently contains total market appreciation of some $430 million in excess of its $15.6 billion book value.

With regard to the major elements of the Corporation's income, 1984 insurance premium assessments amounted to $1.254 billion, income from the investment portfolio amounted to $1.495 billion, and $283 million represented earnings on advances and assets related to our liquidation activities and assistance transactions.

In the area of availability of funds for the Corporation's operations, we have built exceptional liquidity into our resources. We have provided in the appendix a schedule of our operating cash flows projected for the 12-month period beginning July 1, 1985, which reveals a residual funds' flow of $7.1 billion.

We should also note that over the years, we have been able to utilize the credit facilities of the Federal Reserve System in a number of failing and failed bank situations, such as Franklin National and Continental Illinois, in scheduling over time the repayment of debt extended those institutions through the Fed's discount window.

This facility enables the FDIC to further refine our funds' flows by coordinating repayment schedules with asset collections from liquidation activities at those institutions.

As is apparent from the data presented, the combination of resources, income, and funds' flows has enabled the Corporation to absorb without strain the adverse impact of closed bank activity while strengthening our reserves, even over this very difficult 5-year period.

The subcommittee has also requested the nature and amount of contingent liabilities of the FDIC arising from assistance provided failing banks in previous years. The ready answer is that the FDIC has no contingent liabilities other than those related to banks which will fail in the future, on which estimates are impossible to make.

By policy, the Corporation establishes estimated allowances for losses shortly after a bank fails. These allowances are also established for those banks involved in assisted merger transactions.

Thus, the balance sheet presentation of "assets acquired from failures of insured banks" is net of estimated allowance for losses.

These loss reserves, including estimated future cash outlays at present value, are reflected on the year-end 1984 balance sheet at a total of $2.430 billion.

We should also note that the Continental Illinois transaction has been booked, according to generally accepted accounting principles, with a separate line presentation on our balance sheet—Assets Acquired/Liabilities Incurred in Assistance to Insured Banks.

At the time of the transaction, an estimate of the ultimate collectibility of booked assets was simply not possible. The Corporation's liquidation division is completing its initial determination of the net realization value of the transferred loan portfolio at the present time, and an appropriate allowance for losses will be established by year-end 1985 against this year's revenues.

We continue to view this assistance transaction favorably, and are confident that the ultimate overall cost, if any, to the insurance fund will not be material. For your convenience, we have attached a copy of the disclosure on this transaction contained in our 1984 annual report as exhibit I.

The subcommittee has also requested comment on the kinds of amounts of financial obligations we anticipate during the next 12 to 18 months. As FDIC Director of Bank Supervision Shumway testified yesterday, the number and deposits of problem institutions appear not yet to have peaked.

Based on the level of bank failures this year, and the size of our problem list, we are currently projecting at least 100 bank failures in 1986.

We are, therefore, planning for a continued level of activities which will present the same kinds and amounts of financial obligations as we have experienced over the past 18 months.

Under these conditions, we will continue our present posture of maintaining a high degree of liquidity in our balance sheet and concentrating on the sale at the time of failure of more bank assets to purchasing organizations.

We believe that the trend of our financial strength and resources over the past 5 years has demonstrated beyond question our ability to cope with any foreseeable contingencies without financial strain, thereby assuring the safety of depositors in insured institutions.

We, likewise, will continue to move aggressively in the areas of supervision, enforcement and disclosure. We are, of course, additionally devoting considerable resources to planning efforts for contingencies involving individual banks and large numbers of failed banks.

The environment clearly mandates that we be imaginative and responsive to particular situations as they arise if we are to remain a symbol of confidence to the banking public.

I would be remiss if I did not press our case against the insurance of brokered deposits. Chairman Isaac has frequently testified on and documented this massive abuse which we see as the primary threat against the soundness of the Federal deposit insurance system.

The issue is basic. The deposit insurance system was never designed to enable banks which would otherwise be unable to do so, to attract brokered deposits solely through the Federal guarantee. Without the Federal guarantee, the flow of funds to weak institutions would cease in a competitive free market. We need your help in containing this most serious threat to the deposit insurance system.

Thank you, Mr. Chairman. I will be pleased to respond to any questions you or members of the subcommittee may have.

[The prepared statement of Mr. Poling on behalf of the Federal Deposit Corporation follows:]

STATEMENT ON

THE FINANCIAL RESOURCES AND CONDITION OF THE FEDERAL DEPOSIT INSURANCE CORPORATION

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

BY

STANLEY J. POLING
DIRECTOR
DIVISION OF ACCOUNTING AND CORPORATE SERVICES
FEDERAL DEPOSIT INSURANCE CORPORATION

Room 2128, Rayburn House Office Building
September 12, 1985
10:00 a.m.

Mr. Chairman, members of the Subcommittee, we are pleased to have this opportunity to provide testimony on the financial resources and condition of the FDIC as the Subcommittee continues its evaluation of the need for modifications to our system of Federal deposit insurance.

As you are aware, the FDIC has over the past five years, dealt with a post-World War II record number of bank failures throughout the United States. We have responded to 11 bank failures in 1981, 42 in 1982, 48 in 1983, 79 in 1984 and 78 so far in 1985. This period has been difficult for the Corporation and its employees and we see no letup in the immediate future.

Although failures since 1981 involved over $30 billion in bank assets, exclusive of Continental Illinois, the resources of the FDIC have been strengthened rather than diminished over the period. The deposit insurance fund, which is defined as the FDIC's net worth, has increased from $11.1 billion at the beginning of 1981 to its current level at $18.8 billion - more than a 70% growth rate. Moreover, the Fund as a percentage of insured deposits during this period increased from 1.21% to approximately 1.26%, continuing a trend started in the mid-1970's. The ability of the insurance fund to grow during a period of frequent bank failures is a tribute to the inherent strength of the Federal deposit insurance system. The growth of the fund has been achieved through: (1) a broad assessment base and system that appears actuarily sound in terms of the volume of failures in the insured system; (2) a large and growing investment portfolio of U.S. Treasury securities; and (3) a range of flexibility which allows the FDIC to respond to failing and failed bank situations in ways which are designed to minimize insurance losses.

We submit that the FDIC has functioned exactly as it was designed in 1933...a self-help safety net supported by a broad-based industry's insurance premiums. With a current income stream in excess of $3 billion annually, the FDIC does not use a single dollar of taxpayer funds. We at the FDIC are fully confident of the ability to maintain this tradition.

In response to the specific areas requested in the invitation to this hearing, we have presented in an appendix, summary financial statements of condition and income of the FDIC for the last five years. We also have provided a financial statement as of July 31, 1985. The statements present the major asset, liability, revenue and expense components of our financial position. Further and more detailed presentations are contained in our annual reports which are available to the Subcommittee.

Review of our current financial statements quickly reveals the financial resources available for the Corporation's insurance responsibilities. The major components can be aggregated as the $18.8 billion deposit insurance fund, annual gross income (largely from investments and insurance premiums) now in excess of $3.0 billion, and additionally, the Corporation's statutory authority...never used...to borrow up to $3 billion from the United States Treasury.

The bulk of the $18.8 billion deposit insurance fund consists of $15.6 billion invested by law in U.S. Treasury securities. That portfolio is highly liquid with an average maturity of approximately two years and one month. The portfolio presently contains total market appreciation of some $430 million in excess of its $15.6 billion book value. With regard to the major elements of the Corporation's income, 1984 insurance premium assessments amounted to $1.254 billion, income from the investment portfolio amounted to $1.495 billion and $283 million represented earnings on advances and assets related to our liquidation activities and assistance transactions.

In the area of availability of funds for the Corporation's operations, we have built exceptional liquidity into our resources. We have provided in the appendix a schedule of our operating cash flows projected for the twelve-month period beginning July 1, 1985, which reveals a residual funds' flow of $7.1 billion. We should also note that over the years we have been able to utilize the credit facilities of the Federal Reserve System in a number of failing and failed bank situations, such as Franklin National and Continental Illinois, in scheduling over time, the repayment of debt extended those institutions through the Fed's discount window. This facility enables the FDIC to further refine our funds' flows by coordinating repayment schedules with asset collections from liquidation efforts at those institutions.

As is apparent from the data presented, the combination of resources, income, and funds' flows has enabled the Corporation to absorb without strain, the adverse impact of closed bank activity while strengthening our reserves, even over this very difficult five-year period.

The Subcommittee has also requested the nature and amount of contingent liabilities of the FDIC arising from assistance provided failing banks in previous years. The ready answer is that the FDIC has no contingent liabilities other than those related to banks which will fail in the future...on which estimates are impossible to make. By policy, the

Corporation establishes estimated allowances for losses shortly after a bank fails. These allowances are also established for those banks involved in assisted merger transactions. Thus, the balance sheet presentation of "assets acquired from failures of insured banks" is net of estimated allowance for losses. These loss reserves, including estimated future cash outlays at present value, are reflected on the year-end 1984 balance sheet at a total of $2.430 billion.

We should also note that the Continental Illinois transaction has been booked (according to generally accepted accounting principles) with a separate line presentation on our balance sheet (Assets Acquired/Liabilities Incurred In Assistance to Insured Banks). At the time of the transaction, an estimate of the ultimate collectibility of booked assets was not possible. The Corporation's Liquidation Division is completing its initial determination of the net realization value of the transferred loan portfolio at the present time and an appropriate allowance for losses will be established by year-end 1985 against 1985 revenues. We continue to view this assistance transaction favorably and are confident that the ultimate overall cost, if any, to the insurance fund will not be material. For your convenience, we have attached a copy of the disclosure on this transaction contained in our 1984 Annual Report (Exhibit I).

The Subcommittee has also requested comment on the kinds and amounts of financial obligations we anticipate during the next twelve to eighteen months. AS FDIC Director of Bank Supervision Shumway testified yesterday, the number and deposits of problem institutions appear not yet to have peaked. Based on the level of bank failures this year and the size of our problem list, we are currently projecting at least 100 bank failures in 1986. We are, therefore, planning for a continued level of activity which will present the same kinds and amounts of financial obligations as we have experienced over the past eighteen months. Under these conditions, we will continue our present posture of maintaining a high degree of liquidity in our balance sheet and concentrating on the sale at the time of failure of more bank assets to purchasing organizations.

We believe that the trend of our financial strength and resources over the past five years has demonstrated beyond question our ability to cope with any foreseeable contingencies without financial strain...thereby assuring the safety of depositors in insured institutions. We, likewise, will continue to move aggessively in the areas of supervision, enforcement and disclosure. We are, of course, additionally devoting considerable resources to planning efforts for contingencies involving individual banks and large numbers of failed banks. The environment clearly mandates that we be imaginative and responsive to particular situations as they arise if we are to remain a symbol of confidence to the banking public.

I would be remiss if I did not press our case against the insurance of brokered deposits. Chairman Isaac has frequently testified on and documented this massive abuse which we see as the primary threat against the soundness of the Federal deposit insurance system. The issue is basic...the deposit insurance system was never designed to enable banks which would otherwise be unable to do so, to attract brokered deposits solely through the Federal guarantee. Without the Federal guarantee, the flow of funds to weak institutions would cease in a competitive free market. We need your help in containing this most serious threat to the deposit insurance system.

Thank you, Mr. Chairman. I will be pleased to respond to any questions you or members of the Subcommittee may have.

XXXXX

FOOTNOTE ON CONTINENTAL ILLINOIS
TRANSACTION FROM 1984 ANNUAL
REPORT OF FDIC

EXHIBIT

4. Assets Acquired in Assistance to an Insured Bank:
On July 26, 1984, the FDIC, the Federal Reserve Board, the Comptroller of the Currency and a group of major U.S. banks agreed to provide a "permanent assistance program" to the Continental Illinois National Bank and Trust Company of Chicago ("CINB") and its parent, Continental Illinois Corporation. This program, which became effective on September 26, 1984, after Continental Illinois Corporation shareholder approval, replaced a temporary, emergency assistance package among the same parties that had been in effect since May 1984. Major elements of the new package included a financial assistance plan to remove problem loans from CINB and infuse new capital resources into CINB, the continuation of ongoing lines of credit from the Federal Reserve Board and a group of major U.S. banks to alleviate liquidity pressures and the installation of a new management team. Additionally, the FDIC agreed to commit more capital or other forms of assistance if the permanent assistance program proves to be insufficient for any reason.

The key aspects of the permanent assistance program applicable to the FDIC are embodied in an Implementation Agreement and an Assistance Agreement between the FDIC and CINB, Continental Illinois Corporation, and Continental Illinois Holding Corporation, a new holding company formed to own all Continental Illinois Corporation stock as of the effective date for the purpose of implementing the FDIC Option (described below). Discussed below are the major aspects of the FDIC's participation in the permanent assistance program and their effect on the FDIC financial statements.

The assets acquired by the FDIC in assistance to CINB on the commencement date and as of year end are as follows (in thousands):

	(Commencement Date) September 26, 1984	December 31, 1984
Loans and related assets purchased	$2,000,000	$2,010,313
Promissory note	1,500,000	1,447,116
Preferred stock investment	1,000,000	1,000,000
	$4,500,000	$4,457,429

Loans acquired were selected by CINB with the restrictions that such loans were nonperforming, classified or otherwise of poor quality (i.e., "troubled loans"). Certain foreign loans were excluded from selection. On September 26, 1984, after consummation of the permanent assistance program, CINB transferred $2.0 billion of troubled loans to the FDIC. The unpaid legal principal value of these loans was approximately $3.7 billion.

Also, on September 26, 1984, the FDIC received a promissory note from CINB for $1.5 billion. At CINB's option, the promissory note can be paid anytime within three years by transfer of additional troubled loans (subject to the above restrictions) at CINB's book value as of the date of transfer. Until such time as the promissory note is paid, interest will be charged. As of December 31, 1984, CINB transferred $52,844,000 of additional troubled loans to the FDIC as partial repayment on the original promissory note. As a result, the remaining unpaid principal balance on the note is $1,447,116,000.

The purchase of these assets was, in part, funded by the assumption of $3.5 billion of indebtedness to the Federal Reserve Bank of Chicago (FRB) on behalf of CINB. These borrowings will bear interest at specified rates established by the FRB and the U.S. Treasury. The FDIC will repay these borrowings by making quarterly remittances of its collections, less expenses, on the troubled loans. If there is a shortfall at September 26, 1989, the FDIC will make up such deficiency with its own funds.

4. Assets Acquired in Assistance to an Insured Bank (continued):

The Implementation Agreement provides for the FDIC to be reimbursed each quarter for its expenses related to administering the transferred loan portfolio and for interest paid on the indebtedness to the FRB which it assumed. Thus, such costs are recorded as assets. The FDIC and CINB have entered into a service agreement whereby CINB will administer the transferred loan portfolio on behalf of the FDIC. The FDIC is also permitted to establish a special reserve account from troubled loan collections. The balance in this account, if any, reverts to the FDIC in those quarters when loan collections have been insufficient to cover interest owing on the indebtedness which it assumed. For financial accounting purposes, cash collections received on the transferred loan portfolio (plus certain other amounts) are applied quarterly in accordance with the Implementation Agreement terms, as follows: 1) to the administrative expenses paid by the FDIC, 2) to the interest owing on the assumed indebtedness; 3) to fund the special reserve account such that this account plus accrued interest thereon is at least $75 million; and 4) to principal owing under the FRB Agreement. The FDIC is entitled to receive interest on the cumulative deficiencies between cash collections and the costs incurred in administering the troubled loans and the interest on the assumed debt. Further, CINB has assigned to the FDIC all its existing and future claims against any party which may be related to any loss incurred in connection with any transferred loan.

Total cash flow consists of the above collections of principal and interest on the transferred loan portfolio, interest payments on the CINB promissory note and interest earned on daily collections. As of December 31, 1984, the FDIC received cash flow totaling $147,044,000. Cash flow was applied to administrative costs and interest expense of $3,224,000 and $94,564,000 respectively, and to establish a special reserve account balance of $49,256,000. Accordingly, total FDIC obligations for purposes of exercising the FDIC option (discussed below) are $3.457 billion. The collection results during this period should not necessarily be considered indicative of the ultimate loan portfolio collectibility.

Ultimate collection results on the transferred loan portfolio are subject to significant uncertainties because of the financially troubled nature of the borrowers and the effects of general economic conditions on their industries. Due to the number and complexity of the loans within the transferred loan portfolio, an estimate of the ultimate collectibility has not been completed by the FDIC. Accordingly, no determination has been made as to whether or not any allowance for loss related to the CINB permanent assistance program is necessary. Consequently, none has been recorded in the financial statements for the year ended December 31, 1984. The Corporation expects to complete its initial determination of the estimated net realization on the transferred loan portfolio during 1985.

The FDIC holds an option to acquire up to 40.3 million shares of Continental Illinois Corporation common stock. The shares subject to the option are owned by Continental Illinois Holding Corporation, which is owned by the former stockholders of Continental Illinois Corporation. The option cannot be exercised prior to the fifth anniversary of the commencement date, September 26, 1989. Further, the option is exercisable only if the FDIC suffers a loss (disregarding any profit or loss from the FDIC's interest in Continental Illinois Corporation preferred or common stock) on the transferred loan portfolio, including unrecovered administrative costs and interest expense. If the FDIC suffers a loss, the FDIC will be entitled to retain any remaining transferred loans and to exercise the FDIC Option for one share of Continental Illinois Corporation common stock for every $20 of loss, at the exercise price of $0.00001 per share of common stock. No value has been assigned to the FDIC's right to exercise this option as of December 31, 1984. If the FDIC does not suffer any loss under the permanent assistance program, all remaining loans and other assets acquired will be returned to CINB and the option would not be exercisable.

The FDIC also purchased $1 billion of two non-voting, Continental Illinois Corporation, preferred stock issues. The proceeds of these issues were transferred to CINB in the form of a capital contribution. The Junior Perpetual Convertible Preference Stock, in the amount of $720 million, is convertible into 160 million shares of Continental Illinois Corporation common stock upon sale or transfer by the FDIC. Dividends are to be received on this preferred stock only to the extent that dividends are paid on the Continental Illinois Corporation common stock and are equivalent to that which would be paid on 160 million shares of common stock. The Adjustable Rate Preferred Stock, Class A, in the amount of $280 million, is a cumulative issue that is callable at the option of Continental Illinois Corporation. The issuer also has the option to pay dividends on this issue in the form of additional shares of this issue or cash until the third anniversary of their original issue date.

BEST COPY AVAILABLE

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENT OF FINANCIAL POSITION
July 31, 1985
(In Millions)

ASSETS

CASH	$ 81
INVESTMENT IN U. S. TREASURY OBLIGATIONS	15,583
OTHER ASSETS, principally accrued interest receivable on investments	464
CERTIFICATES AND NOTES RECEIVABLE FROM INSURED BANKS	636
ASSETS ACQUIRED IN ASSISTANCE TO AN INSURED BANK	4,274
ASSETS ACQUIRED FROM FAILURES OF INSURED BANKS	2,745
PROPERTY AND BUILDINGS	42
TOTAL ASSETS	$ 23,813

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENT OF FINANCIAL POSITION
July 31, 1985
(In Millions)

LIABILITIES AND THE DEPOSIT INSURANCE FUND

ACCOUNTS PAYABLE, ACCRUED LIABILITIES AND ESCROW FUNDS	$ 76
NET ASSESSMENT INCOME CREDITS DUE TO INSURED BANKS	
Available July 1, 1986 (Estimated)	98
Available July 1, 1985	34
UNEARNED ASSESSMENTS:	
To be apportioned to fund (Estimated)	86
To be apportioned to banks (Estimated)	129
LIABILITIES INCURRED IN ASSISTANCE TO INSURED BANKS	3,730
LIABILITIES INCURRED FROM FAILURES OF INSURED BANKS	795
TOTAL LIABILITIES	4,994
DEPOSIT INSURANCE FUND	18,819
TOTAL LIABILITIES AND THE DEPOSIT INSURANCE FUND	$ 23,813

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENT OF INCOME AND THE DEPOSIT INSURANCE FUND
FOR THE SEVEN MONTHS ENDED JULY 31, 1985
(In Millions)

INCOME

Gross assessments earned	$ 748
Provision for assessment credits	98
Net assessments earned	650
Interest on U. S. Treasury obligations	918
Interest on notes receivable	22
Interest on assets in liquidation	150
Other income	31
TOTAL INCOME	1,771

EXPENSES AND LOSSES

Administrative operating expenses	91
Merger assistance losses and expenses	17
Provision for insurance losses	0
Nonrecoverable insurance expenses	6
TOTAL EXPENSES AND LOSSES	114
NET INCOME	1,657
DEPOSIT INSURANCE FUND - January 1	17,162
DEPOSIT INSURANCE FUND - July 31	$18,819

APPENDIX

344.

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENTS OF FINANCIAL POSITION
FOR THE YEARS ENDED
December 31, 1984, 1983, 1982, 1981, & 1980
(in millions)

	1984	1983	1982	1981	1980
ASSETS:					
CASH	$ 4	$ 89	$ 1	$ 0	$ 2
INVESTMENT IN U. S. TREASURY OBLIGATIONS	14,436	13,992	13,252	12,005	10,094
OTHER ASSETS, principally accrued interest receivable on investments	394	393	350	239	235
CERTIFICATES AND NOTES RECEIVABLE FROM INSURED BANKS	561	424	705	428	472
ASSETS ACQUIRED IN ASSISTANCE TO AN INSURED BANK	4,457	0	0	0	0
ASSETS ACQUIRED FROM FAILURES OF INSURED BANKS	2,144	1,992	714	547	810
PROPERTY AND BUILDINGS	42	37	34	23	23
TOTAL ASSETS	$ 22,038	$ 16,927	$ 15,056	$ 13,242	$ 11,636

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENTS OF FINANCIAL POSITION
FOR THE YEARS ENDED
December 31, 1984, 1983, 1982, 1981, & 1980
(in millions)

	1984	1983	1982	1981	1980
LIABILITIES AND THE DEPOSIT INSURANCE FUND:					
ACCOUNTS PAYABLE, ACCRUED LIABILITIES AND ESCROW FUNDS	$ 108	$ 80	$ 98	$ 47	$ 33
NET ASSESSMENT INCOME CREDITS DUE TO INSURED BANKS					
Available July 1, 1985	68	0	0	0	0
Available July 1, 1984	0	164	0	0	0
Available July 1, 1983	0	0	96	0	0
Available July 1, 1982	0	0	0	129	0
Available July 1, 1981	0	0	0	0	569
LIABILITIES INCURRED IN ASSISTANCE TO INSURED BANKS	3,040	0	0	0	0
LIABILITIES INCURRED FROM FAILURES OF INSURED BANKS	860	1,254	1,091	820	14
TOTAL LIABILITIES	4,076	1,498	1,285	996	616
DEPOSIT INSURANCE FUND	17,162	15,429	13,771	12,246	11,020
TOTAL LIABILITIES AND THE DEPOSIT INSURANCE FUND	$ 22,038	$ 16,927	$ 15,056	$ 13,242	$ 11,636

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENTS OF INCOME AND THE DEPOSIT INSURANCE FUND
FOR THE YEARS ENDED
December 31, 1984, 1983, 1982, 1981, & 1980
(in millions)

	1984	1983	1982	1981	1980
INCOME:					
Gross assessments earned	$ 1,323	$ 1,216	$ 1,109	$ 1,041	$ 953
Provision for assessment credits	69	165	96	119	522
Net assessments earned	1,254	1,051	1,013	922	431
Interest on U. S. Treasury oblibations	1,495	1,404	1,370	1,115	863
Interest on notes receivable	112	65	79	32	13
Interest on assets in liquidation	169	91	54	2	2
Other income	2	17	6	3	1
TOTAL INCOME	3,032	2,628	2,524	2,074	1,310
EXPENSES AND LOSSES:					
Administrative operating expenses	151	136	130	127	118
Merger assistance losses and expenses	198	128	681	388	0
Provision for insurance losses	933	675	126	320	(38)
Nonrecoverable insurance expenses	17	31	62	13	3
TOTAL EXPENSES AND LOSSES	1,299	970	999	848	83
NET INCOME	1,733	1,658	1,525	1,226	1,227
DEPOSIT INSURANCE FUND - January 1	15,429	13,771	12,246	11,020	9,793
DEPOSIT INSURANCE FUND - December 31	$ 17,162	$ 15,429	$ 13,771	$ 12,246	$ 11,020

Reclassifications have been made to the 1983, 1982, 1981, and 1980 financial statements to conform to the presentation used in 1984.

Federal Deposit Insurance Corporation
Residual Funds & Cash Flow Projection
July 1, 1985 through June 30, 1986
(In Millions of Dollars)

	07/85	08/85	09/85	10/85	11/85	12/85	01/86	02/86	03/86	04/86	05/86	06/86	TOTAL
Receipts													
Maturing Gov't. Securities	884	509	283	300	300	250	0	300	300	0	296	400	3822
Int.on Gov't. Securities	82	300	43	59	253	103	81	284	23	46	248	85	1607
Bank Assessments	250	407	0	0	0	0	268	437	0	0	0	0	1362
Notes Receivable	12	3	0	8	0	1	10	2	0	8	0	0	44
Collection on Assets & Misc. Income	125	125	125	125	125	125	125	125	125	125	125	125	1500
Total	1353	1344	451	492	678	479	484	1148	448	179	669	610	8335
Disbursements:													
Expenses: (Admin, Non Recov.Ins. & Liq.)	14	14	14	14	14	14	15	15	15	15	15	15	174
	20	20	20	20	20	20	20	20	20	20	20	20	240
Notes Payable & Indebtedness	2	0	76	275	0	76	17	2	95	86	0	76	705
Income Maintenance Agreements	19	1	1	15	1	2	18	2	2	20	2	2	85
Total	55	35	111	324	35	112	70	39	132	141	37	113	1204
Total Residual Funds	1298	1309	340	168	643	367	414	1109	316	38	632	497	7131

Chairman **St Germain**. Mr. Poling, there is something that bothers me. Maybe you could help clarify. I don't pretend to be an accountant.

You state that there are no contingent liabilities other than those that might occur in the future, that you are unaware of.

Mr. **Poling**. That is correct.

Chairman **St Germain**. As you told our staff, you don't have contingent liabilities because you have set up reserves for the present ones.

Mr. **Poling**. No; because it is impossible to estimate liabilities of future failed banks.

Chairman **St Germain**. Presently, you have no contingent liabilities?

Mr. **Poling**. No; we book them. They are contained in our financial statements.

Chairman **St Germain**. Take Continental Illinois, don't you have a liability there that you are not specifically aware of? We will get back to this again later.

Mr. **Poling**. Yes, sir, but it is presented on a line by line basis.

Chairman **St Germain**. It is in your report?

Mr. **Poling**. Yes.

Chairman **St Germain**. You stated that in your annual report?

Mr. **Poling**. Surely. We have two full pages of footnotes.

Chairman **St Germain**. Mr. Stearns, on behalf of the FSLIC.

STATEMENT OF PETER O. STEARNS, DIRECTOR, FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

Mr. **Stearns**. Thank you, Mr. Chairman and members of the subcommittee, we are pleased to have this opportunity to provide to you a status report on the condition of the Federal Savings and Loan Insurance Corporation, the FSLIC.

Over 3,000 savings institutions prominently display our FSLIC seal which, for more than 50 years, has indeed been one of the most stable signs in our economy.

A major factor in this stability is the FSLIC insurance fund, but one element of a strong and coherent system of deposit insurance. Behind the financial resources of the FSLIC stands the resources of the Federal Home Loan Bank Systems, the regulatory powers of the Federal Home Loan Bank Board, the supervisory capabilities of the Federal Home Loan Banks, the information provided by an extensive reporting and examination system, and strong Federal legislation.

It is my strong conviction that this independent deposit insurance system, combined with the Federal Home Loan Bank System is working. As intended by the System's architects, the fund has been able to absorb losses without disturbing depositor confidence.

Any insurance fund is designed to accumulate reserves when demands are small, and utilize those reserves when demands increase. We are functioning as designed, and in my written testimony have described several new steps to further strengthen our position and to utilize the full resources of the complete deposit insurance system.

We fully understand the importance of our role in maintaining public confidence in our financial system, and are grateful that the Congress stands with us in facing the challenges ahead.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Stearns follows:]

STATEMENT OF PETER O. STEARNS, DIRECTOR, FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to appear before you and describe the financial resources and condition of the Federal Savings and Loan Insurance Corporation -- the FSLIC. Yesterday, Mr. Eric Hemel of the Federal Home Loan Bank Board ("Board") staff described for you the general condition of the thrift industry and the major historical events that provide the backdrop for today's financial scene. I intend to proceed without repeating his summary, and describe the resources FSLIC can deploy to meet the challenges facing it, and outline many of the initiatives we are using in our current operations. I do not hesitate to say that we at the FSLIC do not know, nor does anyone know, the true extent of the problems the future may hold. Things could turn out to be better or worse than we presently can forecast. My goal as Director of the FSLIC has been to manage our available resources as efficiently and effectively as possible. I plan to tell you today how this has been done, to describe for you the tools that we employ, and their intended use in managing future problem cases.

RESOURCES

Reserves. FSLIC's primary resource is its insurance fund. As of July 31, 1985, the date of our most recent internal but unaudited financial statement, FSLIC's total assets were $10,400,683,000 and its total liabilities were $3,793,522,000. Total insurance reserves, or the amount by which assets exceed liabilities, were $6,607,161,000. This reserve has two components, the primary reserve ($5,852,206,000) and the secondary reserve ($754,955,000). The secondary reserve is based on 1961 special premium legislation. It is the repository of all special premiums paid into this reserve between January 1, 1962 and January 1, 1970, and all return on secondary reserve investments. A portion of the reserve was refunded to members between 1974 and 1979. The secondary reserve accounts continue to accrue interest and must eventually be paid back to the account holders unless the primary revenue is insufficient to meet FSLIC's losses. Current legislation also permits the FSLIC to use both reserves simultaneously should conditions warrant and should the Board resolve to do so.

Under current law, when the primary is equal to or greater than 2 percent of members' deposits, the annual premium is waived for all members who have paid twenty or more annual premiums. Currently this reserve represents 0.71% of member deposits.

Premium Income. Members must pay a cash premium to FSLIC equal to 1/12 of 1 per centum of member insured and uninsured deposits. This fiscal year, starting October 1, 1984, income from the regular premium to July 31, 1985 totals $574,047,000. The regular premium is first paid at the time of membership and annually thereafter, unless by regulation the Board requires payment semiannually. Should the Board decide to assess semiannually, the effect of semiannual assessments would be to increase premium income to the fund by about $50-70 million dollars each year. The Board is currently awaiting public comments on a proposed regulation on semi-annual premium collection.

To recoup losses and expenses of FSLIC, additional premiums may be assessed by FSLIC, not exceeding 1/8 of 1 per centum of member insured and uninsured deposits in any year. To date, the board has assessed three special premiums (March 11, June 11, and September 10, 1985) each amounting to 1/32 of 1 per centum of deposits. These three assessments totaled $751,115,401, with an annualized estimate of over $1 billion per year.

Investment Income. As of July 31, 1985, FSLIC's investment portfolio totaled $6,090,849,000, consisting mostly of Treasury obligations. The returns on the investment portfolio recently have approximated 8 percent. Average time to maturity is about 27.5 months. The FSLIC's investment policy has three key parameters: (1) all investments must be backed by the full faith and credit of the U.S. Government, (2) that income should be maximized within those constraints, and (3) average time to maturity must not exceed three years in order to assure proper liquidity and to minimize interest rate risk.

Lines of Credit.

From Members. At any time, the Board may require that members deposit cash with the FSLIC. The aggregate total of any such deposits may not exceed 1 per centum of members' insured and uninsured deposits, but members may be required to maintain the deposit at any level equal to or below 1 per centum. FSLIC must pay interest on the deposit equal to the average rate of return FSLIC receives from its investment in government securities. There is no prescribed time limit for return of this deposit to members. To date, this line of credit has never been utilized, and could produce over $9 billion to FSLIC.

From the Federal Home Loan Banks (FHLB's). FSLIC may borrow from any of the twelve Federal home loan banks, limited only by the financial capacity of the Banks and their willingness to lend to FSLIC. Each bank's primary business is providing liquidity to thrift institutions, and each are profit making, though not profit maximizing, operations. The FHLB's are well capitalized, at nearly $9 billion. They are able to borrow money in the public money markets at rates just slightly above Treasury rates. Their ability to raise low cost money is largely due to their status as government sponsored agencies, augmented by a strong capital base which is among the highest of any large bank in the world,and a portfolio of collateralized loans. There is some limit to the loans the FHLB's may make in the short run to FSLIC without raising the cost of money to the FHLB's. That limit is imprecise and undefined, and totally market dependent. To date, FSLIC has borrowed $900 million dollars from the FHLB's which has been passed through FSLIC in collateralized loans from which FSLIC expects to experience no financial losses. It should also be noted that the FHLB system has an unused $4 billion dollar line of credit to the U.S. Treasury. FHLB borrows from the Treasury could be passed through to the FSLIC. A detailed description of the Federal Home Loan Bank System is attached to this statement.

From the U.S. Treasury. FSLIC has a direct line of credit from the U.S. Treasury in the amount of $750 million dollars. This line was established by legislation in June, 1950 and has never been used. (It is interesting to note that if the 1950 line of credit had been adjusted for inflation to 1984, the line would now be about $3.0 billion dollars instead of $750 million.)

Summary. FSLIC fund income from all sources can be used for operating expenses, including all costs associated with resolving FSLIC's case load.

FSLIC Sources of Funds Summary

(000's omitted)

$5,852,206	Primary reserve 7/31/85
$754,955	Secondary reserve 7/31/85
$688,856	Estimated annual income from regular premiums
$1,011,115	Estimated income from additional premiums
$560,000	Estimated annual investment income
$8,222,810	Estimated size of 1% deposit as of 7/31/85
$750,000	FSLIC line of credit -- U.S. Treasury
$4,000,000	FHLB line of credit -- U. S. Treasury

Financial Statements

A more detailed look at FSLIC's financial condition can be obtained from a review of the major asset, liability, revenue, and expense categories in the most recent audited financial statements dated December 31, 1984, a copy of which has been previously provided to the Congress by the Comptroller General of the U.S. General Accounting Office. I will try not to repeat the many detailed footnotes included in those statements, but to combine and summarize them in describing the major points.

Assets. Assets can be subdivided into two broad categories -- current and non-current. Current assets are cash, accounts receivable, and investments. All other assets are non-current. Current assets account for 66.8% of total assets.

Subrogated accounts and secured advances due from receivers. These accounts represent claims that FSLIC in its corporate capacity possesses in relation to FSLIC in its receivership capacities. That is, when the Board decides that an institution must be liquidated, FSLIC is appointed as receiver for the assets involved and a receivership entity is established. FSLIC (Corporate) does not have title to the assets, which are held in receivership, but does stand in the place of the former insured depositors, having paid insurance on insured deposits. FSLIC may also be a secured creditor for advances it has made or guaranteed. Therefore, subrogated accounts due from receivers are claims equal to the cash FSLIC was required to pay out to cover the the insured deposits. The contra-asset accounts for possible future losses reduce the value of these claims to a net value that represents the amount FSLIC (Corporate) expects to receive in cash over time from FSLIC (receiver) as the assets are gradually liquidated. For example, subrogated accounts and FSLIC secured advances due total $1,799,311,933, and the contra-asset losses total $702,724,922. The net value, $1,096,587,011 represents the cash FSLIC expects to obtain from receiver assets, the majority of which are various kinds of real estate and mortgages.

Loans. $700 million of the $922,349,947 consists of pass-through loans of funds borrowed from FHLB's.

Income Capital and Net Worth Certificates. (ICC, NWC) These certificates essentially represent equity positions in troubled institutions, obtained in exchange for a FSLIC note. Expected losses on certificates are difficult to determine, and the allowance for loss is periodically adjusted as information is developed on the true worth of the issuing institutions. ICC and NWC requirements differ: ICC's may be purchased on terms determined by FSLIC from any institution qualifying for assistance; NWC issuers meet more limited statutory standards. The FSLIC notes pay interest and are used by the recipient institutions to bolster their net worth.

Mortgage Loans and Real Estate. These assets are similar in type to the majority of assets held by FSLIC as receiver, but are assets held directly by FSLIC in its corporate capacity. They are being managed directly by FSLIC (Corporate) and will also be liquidated to cash over time.

FSLIC Asset Summary - December 31, 1984

		Percent of Total Assets
Current assets	$5,972,328,558	66.9%
Loans	922,349,947	10.3%
Net subrogated accounts	1,096,587,011	12.3%
Net ICC's/NWC's	718,833,393	8.0%
Net Mortgage Loans and Real Estate	227,488,909	2.5%
	$8,937,587,818	100.0%

Liabilities and Reserves

Notes payable to FHLB's. All $700 million in these notes is offset by an equivalent asset in "Loans to Insured Institutions."

Notes payable to insured institutions. The majority of these notes were issued in exchange for ICC's or NWC's. They pay interest at various rates and usually mature in five to ten years.

Allowance for Possible Future Losses under Contribution Agreements. This figure represents the sum of all expected future cash payments required by existing assistance agreements, which are contractual obligations. As cash is paid out over time to fulfill the terms of these agreements the allowance is reduced by an amount equal to the cash paid. Conversely, when new obligations are formed, usually multi-year agreements, the expected cash out-flow for all years is summed, expensed in the year the obligation is formed, and added to the allowance for losses. The allowance for loss accounts are reviewed and recomputed quarterly based on the most recent and relevant information, and are adjusted as necessary to reflect our current estimate of future losses under existing agreements.

Reserves. The reserves have previously been discussed in this presentation.

FSLIC Liabilities Summary - December 31, 1984

		Percent of Total Assets
Miscellaneous Liabilities	$ 90,724,313	1.1%
Notes payable to FHLB's	700,000,000	7.8%
Notes payable to institutions	834,834,936	9.3%
Allowance for losses	1,706,261,101	19.1%
Reserves	5,605,767,468	62.7%
TOTAL	$8,937,587,818	100.0%
	==============	========

Revenue

The vast majority of income flows from premiums assessed on insured members and from interest on the FSLIC investment portfolio. Minor amounts flow in from loan interest and from gains on sale of corporately held real estate and mortgages. It should be noted that cash inflow resulting from the conversion of a non-current asset to cash as in the case of cash dividends from a receiver, is not income, but simply a change in form of an asset already held.

FSLIC Income summary - Year ending December 31, 1984

			Percent of Total Income
Regular premium		$ 596,940,890	45.1%
Additional premium		0	0%
Investments		655,265,644	49.5%
Other		72,771,262	5.4%
	Total	$1,324,977,796	100.0%
		=============	======

Expenses

Expenses can be broadly categorized into three major segments as those relating to overhead (salaries, etc.), interest payments on FSLIC notes, and additions to the various loss provision accounts. Interest applied to the secondary reserve is shown as an expense in order to offset the interest income received from investment of the secondary reserve, and was included in the "Interest on Investments" account.

The major expense item is the Provision for Possible Future Losses on Contribution Agreements. As explained in the preceding section on liabilities, as agreements are entered into, the sum of all expected future cash contributions from FSLIC are listed as an expense on FSLIC's statement, and added to the liability account "Allowance for Losses," which represents the cumulative effect of agreements and payments to date. For example, in the case of a FSLIC assisted sale in 1984 of a troubled institution, FSLIC may agree to subsidize the purchaser at the rate of $10 per year for five years, a total of $50, with the first payment due in 1985. 1984's financial statements will show an expense of $50 as a provision for future losses, and the liability account for that particular allowance for losses would have increased by $50. No actual cash flow will occur until 1985, when the first $10 payment is made.

The remaining provision expense accounts operate in the same manner, to the effect that as FSLIC becomes aware of possible future losses in each of the categories, the total amount of expected loss is expensed in the year FSLIC recognizes the losses, and the related balance sheet allowance account is similarly adjusted.

FSLIC Expense Summary - Year Ending December 31, 1984

		Percent of total expense
Overhead	$ 51,266,391	2.4%
Interest (except to secondary reserve)	113,244,373	5.3%
Provision for losses	1,978,524,311	92.3%
Total	$2,143,035,075	100.0%

FSLIC Provision for Loss Summary - Year ending December 31, 1984

		Percent of total provisions
Contribution agreements	$1,293,503,676	65.4%
Mortgage Loans and real estate	62,771,576	3.2%
ICC's and NWC's	45,357,000	2.3%
Subrogated accounts	516,764,330	26.1%
Secured advances due from receiver	60,127,729	3.0%
	$1,978,524,311	100.0%

Copies of FSLIC's audited financial statements for the year 1980 through 1984 are appended as requested by the committee.

Contingent liabilities

As previously discussed, all firm liabilities that arise from assistance agreements and transactions by FSLIC are expensed in the year FSLIC first becomes aware of the liability. These totals are carried on the balance sheet in the various "Allowance for Possible Future Losses" accounts.

In addition to known liabilities under the terms of the assistance agreements, FSLIC currently has contingent liabilities arising from these agreements estimated to total $203.7 million.

Another category of contingent liabilities is guaranteed bank advances. Bank advances, in general, are secured loans from Federal Home Loan Banks made to member savings institutions. Normally, FSLIC does not become involved in these transactions and the vast majority of bank advances do not involve a FSLIC guarantee.

As of August 31, 1985, FSLIC was the guarantor of bank advances totaling $2,490,570,000, with commitments to guarantee another $2,047,430,000 if needed.

Problem Institutions.

I believe that Eric Hemel's testimony yesterday gave ample evidence that FSLIC is insuring deposits in a thrift industry that is largely healthy and only partially troubled. The interest rate spread pressure of the early 1980's has relaxed, but was the underlying force causing an unwise portion of the industry to engage in poor investment choices that are resulting in increased pressures on the resources of the FSLIC fund today. Nearly all of the cases resolved by FSLIC in 1985 had as the cause of their demise a set of non-performing or overvalued assets. Nearly all of our present caseload appears to involve similar problems, and dominates our thinking in developing approaches for their resolution.

The number of problem institutions and the extent of FSLIC's exposure is not known. Estimates vary widely. All estimates have sets of assumptions, with major variables such as the general condition of the economy, interest rate levels, and both federal and state legislative action. The key variables are time, and the efficiency and effectiveness with which FSLIC exercises all available resources. Above all, it is incorrect to view the FSLIC fund as something apart from the entire Federal Home Loan Bank System. That system includes effective organization, regulation, examination, legislation, and persuasion, as well as the financial mechanics of the fund outlined earlier in this statement. It is of critical importance that FSLIC's operating head is the Federal Home Bank Board, the regulating agency for federally insured thrifts. As a result, FSLIC staff operates in close proximity to and in concert with the other offices of the Bank Board. Regulations are developed with paramount concern for the FSLIC insurance fund. The regulations on direct investment and asset growth discussed yesterday by Mr. Hemel were actions that did more to protect the FSLIC fund than perhaps any other regulation in the past fifty years. Examiners in the field, helpful legislators in the Congress, and tough Supervisory Agents all help to weave a strong safety net in support of the deposit insurance system and help maintain strong public confidence. Within FSLIC, and with the supervision and support of the Federal Home Loan Bank Board, we are implementing a number of major initiatives to help us meet future obligations. I would like to discuss several of these initiatives.

Financial Preparation.

FSLIC is establishing an internal operating budget system against which to reference future case costs such that the primary reserve ratio is kept above a lower limit of 0.5% (or $4.1 billion based on the July 31, 1985 total deposits), and that obligations are kept within the established quarterly limits. Additionally, all existing liabilities are being closely reviewed to define candidates for possible renegotiation and to insure that no unnecessary liabilities exist. Cash flow management is being improved and correlated more closely with the investment policy, in order to maximize investment income.

Improved Case Resolution Techniques.

All FSLIC cases that are not rehabilitated terminate in either the sale of or the liquidation of a troubled institution. A sale usually is the least costly solution for FSLIC, and is the preferred solution. Less of an institution's going concern value is lost, FSLIC's direct costs are lower, and a sale is least corrosive on public confidence. We are planning shortly to propose to OMB to substantially increase the numbers of personnel in our Mergers and Acquisitions Division to nearly triple in size over the next two years, and increase its effectiveness equivalently. A separate marketing research section has been created, with a goal towards aggressive, informed, marketing of troubled thrifts. Particularly with the predominance of asset problems, our bid packages require more research, better documentation, and more accurate pricing. We already have received much positive feedback about the program, and the interest from potential acquirors is on the rise.

Management Consignment Program

The Management Consignment Program (MCP) is a new tool used by the Bank Board as a containment, evaluating and rehabilitation device. It is also meant to minimize FSLIC's eventual solution costs in the event the MCP participant is unable to be rehabilitated. The program has been most useful thus far in handling large, troubled institutions whose bad asset problems have surfaced, but are not defined. Assets and liabilities are passed through a receivership to a federal mutual that is formed for the purpose of keeping their assets and liabilities in a going concern mode of operation. All depositors are fully protected up to the maximum $100,000 per account.

Day-to-day supervision is delegated to the Principal Supervisory Agent (PSA) in the relevant bank district. The MCP entity operates autonomously but under the watchful care of a highly qualified management group hired by the new institution with the PSA's approval, and with boards of directors approved by the Bank Board.

The principal advantage of the program is that it permits rapid supervisory action without the necessity of a final FSLIC case resolution (sale or liquidation), thus terminating the behavior that brought the institution into insolvency but allowing time for a measured unwinding of affairs and close examination of the assets. Such a program also appears to stabilize the deposit outflow at each institution. Each MCP is in a holding pattern, with expert management imported from successful members of the thrift industry attempting to unravel its affairs,and set it on a steady and profitable course. MCP's are usually not immediately salable as they exist, largely because of the unknown asset quality or entangling litigation in progress. The program gives us time to see what we have, evaluate its true market value or rehabilitation potential, and, if necessary, proceed to market it with full knowledge of its condition and good estimates of its fair market price. Orderly marketing or rehabilitation eliminate the more costly liquidation action and the entire process conserves FSLIC's resources. There are presently fourteen MCP's, holding book value assets of about $13.5 billion, and each case has been almost totally unique.

The 406 Association

The Federal Savings and Loan Advisory Council has recommended, and Bank Board staff is evaluating, the establishment of a federally chartered corporation as authorized under Sections 406(a) and (b) of the National Housing Act. FSLIC would be the sole shareholder, and the purpose of the corporation would be to maximize returns to FSLIC from the liquidation of assets held in receivership (currently over $2.0 billion). The details of this arrangement have not been finalized, but FSLIC views the 406 association as a means of replacing its present awkward receivership system with a centralized and controlled mechanism for managing assets received in liquidation. The existing system is a combination of government employees and contracted personnel that is difficult to manage. We presently cannot attract a talented real estate sales force in the sufficient numbers needed to rapidly and efficiently convert real estate assets to cash. The Board itself, however, has made no final decision, pending completion of staff work.

Risk-related Insurance Premium

The Chairman of the Bank Board earlier this year requested legislation that would enable FSLIC to adjust premium assessments by appropriate risk factors. The basic concept of a risk-adjusted system would be to increase the premium in relation to the degree by which an institution's activity exceeds that granted by federal legislation and regulation. The system would be flexible and could be adjusted if warranted by evaluation of risk data and reported information. The matter is undergoing staff study and review, and the Chairman intends to present further testimony on this issue in the near future.

Conclusion.

Mr. Chairman, it has indeed been a pleasure to respond to your questions concerning the Federal Savings and Loan Insurance Corporation, and to outline for you and the other members of your committee not only our present financial condition but how we intend to deploy our resources in the future. I have attempted to convey my belief that although the extent of future problems is not totally clear, we at the FSLIC, with the guidance and support of the Federal Home Loan Bank Board, are facing the future confidently, and are ready to act boldly and with strength in carrying out our duties. We fully understand the importance of our role in maintaining public confidence in our financial system, and are grateful that the Congress stands with us in facing the challenges ahead.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
COMPARATIVE STATEMENT OF CONDITION
DECEMBER 31, 1984 AND 1983

	1984	1983
Assets		
Cash	$ 2,764,236	$ 1,160,313
Insurance Premiums and Accounts Receivable	37,803,382	46,336,719
Investments (Note 2)	5,869,307,301	6,799,195 381
Interest Receivable on Investments	58,296,395	70,840,669
Loans to Insured Institutions (Note 7)	922,349,947	208,749,278
Interest Receivable on Loans to Insured Institutions	4,157,244	3,433,918
Subrogated Accounts in Insured Institutions	1,156,502,895	351,876,053
Less: Allowance for Possible Future Losses	642,597,193	108,800,000
Net Subrogated Accounts (Note 3)	513,905,702	243,076,053
Income Capital and Net Worth Certificates	865,163,795	850,100,000
Dividends Receivable on Net Worth Certificates	526,598	260,572
Less: Allowance for Possible Future Losses	146,857,000	101,500,000
Net Income Capital and Net Worth Certificates (Note 5)	718,833,393	748,860,572
Secured Advances Due from Receiver	642,809,038	-0-
Less: Allowance for Possible Future Losses	60,127,729	-0-
Net Secured Advances Due from Receiver (Note 8)	582,681,309	-0-
Mortgage Loans and Real Estate	297,246,914	253,277,765
Less: Allowance for Possible Future Losses	69,758,005	27,638,989
Net Mortgage Loans and Real Estate	227,488,909	225,638,776
Total Assets	8,937,587,818	8,347,291,679
Liabilities and Reserves		
Accounts Payable and Other Liabilities	55,679,776	33,358,958
Notes Payable to FHLBanks (Note 7)	700,000,000	-0-
Notes Payable to Insured Institutions (Note 6)	834,834,936	842,603,148
Accrued Interest on Notes Payable	35,044,537	38,325,995
Allowance for Possible Future Losses Under Contribution Agreements (Note 4)	1,706,261,101	1,007,582,054
Primary Reserve (Note 9)	4,885,037,594	5,764,260,686
Secondary Reserve (Note 9)	720,729,874	661,160,838
Total Liabilities and Reserves	$ 8,937,587,818	$ 8,347,291,679

The accompanying notes are an integral part of these financial statements.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
COMPARATIVE STATEMENT OF INCOME AND EXPENSE AND RESERVES
FOR THE YEARS ENDED DECEMBER 31, 1984 AND 1983

	1984	1983
Income		
Insurance Premiums (Note 1)	$ 596,940,890	$ 508,491,095
Interest on Investments	655,265,644	604,655,968
Interest on Loans to Insured Institutions	42,396,735	20,200,094
Income on Mortage Loans and Real Estate	18,412,484	28,194,774
Other Income	11,962,043	931,050
Total Income	1,324,977,796	1,162,472,981
Expenses		
Administrative Expenses	1,233,731	1,076,727
Net Loss on Sale of Securities	-0-	17,887,091
Services Rendered by The Federal Home Loan Bank Board (Note 8)	28,365,685	30,276,417
Interest on Notes Payable to FHLBanks	23,785,879	-0-
Interest on Notes Payable to Insured Institutions	89,458,494	66,662,590
Insurance Settlement and Other Expenses	21,666,975	16,928,393
Provision for Possible Future Losses on:		
Contribution Agreements (Note 4)	1,293,503,676	895,178,263
Mortgage Loans and Real Estate	62,771,576	5,000,000
Income Capital and Net Worth Certificates.	45,357,000	(68,400,000)
Subrogated Accounts (Note 3)	516,764,330	103,038,249
Secured Advances Due from Receiver	60,127,729	-0-
Total Expenses	2,143,035,075	1,067,647,730
Net Income (Loss) From Operations	(818,057,279)	94,825,251
Interest Applied to the Secondary Reserve (Note 9)	61,165,813	47,758,026
Net Income (Loss)	(879,223,092)	47,067,225
Reserves at Beginning of Year	6,425,421,524	6,330,843,117
Increase to Secondary Reserve	59,569,036	47,511,182
Reserves at End of Year (Note 9)	$ 5,605,767,468	$ 6,425,421,524

The accompanying notes are an integral part of these financial statements.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE YEARS ENDED DECEMBER 31, 1984 AND 1983

	1984	1983
Source of Funds:		
Net Income (Loss)	$ (879,223,092)	$ 47,067,225
Add (deduct) Items not Requiring, or Generating Cash:		
Depreciation of F&E	27,019	16,559
Provision for Possible Future Losses on:		
Mortgage Loans and Real Estate	62,771,576	5,000,000
Income Capital and Net Worth Certificates	45,357,000	(68,400,000)
Contribution Agreements	1,293,503,676	895,178,263
Subrogated Accounts	533,797,193	108,800,000
Secured Advances Due from Receiver	60,127,729	-0-
Return on Secondary Reserve	61,165,813	47,758,026
Transfer from Secondary Reserve	(1,438,798)	(189,802)
Accretion and Amortization on Investments	(26,341,231)	(96,597,810)
Funds Provided from Operations	1,149,746,885	938,632,461
Increase (Decrease) in:		
Notes Payable - to FHLBanks	700,000,000	-0-
Accounts Payable and Other Liabilities	22,320,818	7,977,931
Decrease (Increase) in:		
Investments and Interest Receivable	967,451,610	(313,971,377)
Accounts and Dividends Receivable	8,267,311	(23,655,880)
Total	2,847,786,624	608,983,135
Application of Funds:		
Increase (Decrease) in:		
Subrogated Accounts	804,626,842	253,427,622
Income Capital , Net Worth Certificates	15,063,795	408,300,000
Amount Paid Under Contribution Agreements	594,824,629	592,954,336
Refund of Secondary Reserve	157,979	57,042
Secured Advances Due from Receiver	642,809,038	-0-
Loans to Insured Institutions and Interest Receivable	714,323,995	(134,239,374)
Mortgage Loans and Real Estate	63,326,753	(105,807,758)
Decrease (Increase) in		
Notes Payable and Accrued Interest	11,049,670	(406,666,414)
Total	2,846,182,701	606,025,454
Increase in Cash	$ 1,603,923	$ 957,681

The accompanying notes are an integral part of these financial statements.

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FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1984 AND 1983

1. Summary of Significant Accounting Policies:

   a) Income Recognition - Insurance Premium Income is recognized as earned when member institutions are assessed.

   b) Generally the Provision for Possible Future Losses is recorded when a default prevention action is taken.

2. Investments - Investment securities are stated at cost, adjusted for amortization of premiums and accretion of discounts. Such amortization and accretion are computed on the level yield method at rates based upon the lives of the related securities. Both amortization and accretions are recognized as an adjustment to Interest on Investments.

   All cash received by the Corporation which is not used to defray operating expenses or for outlays related to assistance to insured institutions and liquidation activities, is invested in U.S. Treasury securities. Other obligations are mostly securities issued by Federal Government Agencies other than the U.S. Treasury which were obtained through the Corporation's default prevention activities. As of December 31, 1984 and 1983, the Corporation's investment portfolio consisted of the following:

	1984		1983	
	Book Value (in thousands)	Market Value	Book Value (in thousands)	Market Value
U.S. Treasury Obligations:				
Overnight Funds	$ 2,334,219	$ 2,334,219	$ 1,946,558	$ 1 946,558
Maturities up to One Year	542,497	545,407	1,488,841	1,484,025
Maturities Over One Year	2,164,708	1,881,044	2,491,754	2,118,038
Subtotal:	5,041,424	4,760,670	5,927,153	5,548,621
Other Obligations:				
Maturities Up to One Year	125	119	-0-	-0-
Maturities Over One Year	827,758	756,045	872,042	802,804
Subtotal:	827,883	756,164	872,042	802,804
Total:	$ 5,869,307	$ 5,516,834	$ 6,799,195	$ 6,351,425

3. Subrogated Accounts - As required by Statute, the FSLIC closes institutions only when there is no default prevention measure that would be less costly than liquidation. In these cases, FSLIC settles insurance claims either by cash payout of insured accounts or by transferring insured accounts to another insured institution. In either case insurance payment is made in exchange for the account holder's claim against the assets of the defaulted institution. Subrogated Accounts represent the total of these outstanding claims. The changes in the Allowance for Possible Future Losses on Subrogated Accounts for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of Year	$ 108,800	$ -0-
Add: Net Provision Charged to Expense	516,764	103,038
Net Premiums	17,033	5,762
Balance, End of Year	$ 642,597	$ 108,800

4. Contribution Agreements - The FSLIC makes contribution agreements to prevent default of an insured institution. Under some of these agreements the Corporation agrees to make, or commits itself to make, certain contributions over time. The FSLIC may incur additional contingent liabilities in excess of Possible Future Losses resulting from uncertainties concerning litigation and other undisclosed liabilities. However, it is management's opinion that these amounts cannot be reasonably estimated. The changes in the Allowance for Possible Future Losses Under Contribution Agreements for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of Year	$ 1,007,582	$ 705,358
Add: Provision Charged to Expense	1,293,504	895,178
Less: Contributions Paid	594,825	592,954
Balance, End of Year	$ 1,706,261	$ 1,007,582

5. Income Capital & Net Worth Certificates - Since 1981 the FSLIC has purchased Income Capital Certificates (ICC's) from insured institutions. The FSLIC records the ICC's at cost. The ICC's earn annual income payments based on the United States Treasury Bill rates. The annual income payments and principal are redeemable upon the issuing institution having profitable operations and attaining a specified net worth level. The changes in the ICC's for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of Year	$ 773,200	$ 404,300
Add: Net Purchases (Decrease) During Year	(52,586)	368,900
	720,614	773,200
Less: Allowance for Possible Future Losses (Cumulative)	142,857	92,750
Balance, End of Year	$ 577,757	$ 680,450

5. (Con't)

In addition, since 1982 the FSLIC has purchased Net Worth Certificates (NWC's) from insured institutions as part of its default prevention activities. NWC's earn annual income payments based on the cost of Federal Home Loan Bank System Obligations plus 1/4 of one percent. Annual income and principal payments are redeemable upon the issuing institution having profitable operations and attaining a specified net worth level. Such payments have been accrued for institutions meeting these requirements. The changes in the NWC's for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of Year	$ 76,900	$ 37,500
Add: Purchases During Year	67,650	39,400
	144,550	76,900
Add: Dividends Receivable	526	261
Less: Allowance for Possible Future Losses (Cumulative)	4,000	8,750
Balance, End of Year	$141,076	$ 68,411

6. Notes Payable to Insured Institutions - The FSLIC has outstanding negotiable notes to purchase ICC's and promissory notes to purchase ICC's and NWC's in the amount of $536,450,000 as of December 31, 1984, and $776,900,000 as of December 31, 1983. Variable interest is paid semiannually based on the cost of Federal Home Loan Bank System Obligations or the average auction yield for United States Treasury Notes with maturities from 5-10 years. In addition to issuing notes to purchase ICC's and NWC's, the FSLIC has also issued other negotiable notes to carry out it default prevention activities in the amount of $298,384,936 as of December 31, 1984, and $65,703,148 as of December 31, 1983.

7. Loans to Insured Institutions - The FSLIC has made loans to insured institutions on occasion as part of its default prevention activities. The outstanding balance of these loans at December 31, 1984 and 1983 were $922,349,947 and $208,749,278, respectively. The majority of the increase was a $700,000,000 collateralized loan to an insured institution.

In order to finance the loan to an insured institution, FSLIC issued a $700,000,000 collateralized note to a FHLBank. Interest on the note is based on the cost of funds of the FHLBank plus twenty basis points. Interest on the loan is based on the monthly weighted average cost of funds charged to members of the FHLBank in which the insured institution is located.

8. Related Party Transactions - The Federal Home Loan Bank Board is an independent Federal agency in the executive branch of government and governs the Federal Savings and Loan Insurance Corporation (FSLIC). The Bank Board assessed the FSLIC for services rendered in the amount of $28,365,685 for 1984 and $30,276,417 for 1983. The principal function of the FSLIC is to insure accounts in savings and loan associations and federal mutual savings banks.

8. (Con't)

In addition, the FSLIC, as part of its default prevention activities, may guarantee repayment of FHLBank advances that were made to certain insured institutions. These guarantees are typically granted on a short-term basis, generally covering advances that are secured. The amount of these advances as of December 31, 1984, totaled $1,715 million and $559 million at December 31, 1983. In the event that it is called upon to honor these guarantees, the FSLIC has claim against any assets pledged as collateral to secure such advances. The FSLIC honored $642,809,038 of guaranteed advances during 1984 and exercised its claim to the assets securing these advances. An allowance for possible future losses in the amount of $60,127,729 was also established.

9. Reserves - The FSLIC's total reserves available for losses consist of the Primary and Secondary Reserves. The Secondary Reserve is the equity of certain institutions in FSLIC based on premium prepayments and related interest not yet paid to these institutions. It is available for losses, but may also be paid back to the institutions depending on FSLIC's financial condition and management's anticipation of losses. Interest of $61,165,813 was credited to the Secondary Reserve based on the yield of FSLIC's investment portfolio. The Primary Reserve is the cumulative net income of the FSLIC since its inception less the interest applied to the Secondary Reserve

	1984	1983
Primary Reserve		
Balance, Beginning of Year	$ 5,764,260,686	$ 5,693,669,737
Prior Period Adjustments	-0-	23,523,724
As Restated	5,764,260,686	5,717,193,461
Net Income (Loss)	(879,223,092)	47,067,225
Balance, End of Year	4,885,037,594	5,764,260,686
Secondary Reserve		
Balance, Beginning of Year	661,160,838	613,649,656
Interest Applied	61,165,813	47,758,026
Transfers and Refunds	(1,596,777)	(246,844)
Balance, End of Year	720,729,874	661,160,838
Total Reserves at End of Year	$ 5,605,767,468	$ 6,425,421,524

10. Retirement Plan - All permanent, full-time and part-time employees who were employed by the FSLIC prior to January 1, 1984, are covered by the contributory Civil Service Retirement Plan. The Corporation makes bi-weekly contributions to the plan equal to the employee's bi-weekly contributions. Employees hired after January 1, 1984 fall under the Social Security Act; however, they also contribute 1.3% and the Corporation 7% to the Civil Service Retirement Plan. The retirement plan expense incurred for calendar years 1984 and 1983 were $258,366 and $241,567 respectively.

11. Given the state of the economy and present condition of the industry, it is possible that FSLIC could sustain additional losses in subsequent accounting periods due to its default prevention actions. Because many of the causes for default are beyond managment's control, the amount of these losses cannot be determined. However, the Corporation believes that its resources, including the right to increase insurance premiums, are sufficient to absorb any such losses over the foreseeable future.

11. (Con't)

The Federal Home Loan Bank Board, as the operating head of FSLIC, on February 22, 1985, authorized FSLIC to assess each insured institution an additional premium for insurance in an amount equal to one-thirty second of one per centum of the total amount of the accounts of the members of each insured institution determined as of December 31, 1984. The additional $245 million insurance premium assessed was paid by each insured institution on or about March 31, 1985. The Bank Board also expressed its intention to consider the assessment of further additional premiums in amounts equal to one thirty second of one per centum on a quarterly basis during 1985. If adopted, such assessments would increase income by an additional $750 million.

Federal Savings and Loan Insurance Corporation
Comparative Statement of Condition
(December 31, 1983 and 1982)*

	1983	1982
Assets		
Cash	$ 1,160,313	$ 262,632
Accounts Receivable	40,226,719	72,941,411
Investments (Notes 1 and 2)	6,790,195,261	6,376,530,250
Interest Receivable on Investments	70,640,099	82,422,387
Loans to Insured Institutions	200,749,270	328,142,476
Interest Receivable on Loans to Insured Institutions	3,433,919	8,280,094
Subrogated Accounts in Insured Institutions	351,076,063	96,448,451
Less Allowance for Possible Future Losses (Note 3)	108,000,000	-0-
Net Subrogated Accounts	243,076,063	96,448,451
Income Capital and Net Worth Certificates	865,100,000	441,800,000
Dividends Receivable on Net Worth Certificates	380,572	-0-
Less Allowance for Possible Future Losses	101,500,000	169,800,000
Net Certificates (Note 5)	749,980,572	271,900,000
Mortgage Loans and Other Assets	253,277,796	375,417,867
Less Allowance for Possible Future Losses	27,638,999	40,440,567
Net Mortgage Loans and Other Assets (Note 1)	225,638,776	334,977,310
Total Assets	$8,347,201,670	$7,536,646,880
Liabilities and Reserves		
Accounts Payable and Other Liabilities	$ 33,358,930	$ 25,301,027
Notes Payable to Insured Institutions (Note 6)	847,903,146	416,903,000
Accrued Interest on Notes Payable	38,325,985	17,750,000
Allowance for Possible Future Losses Under Contribution Agreements (Note 4)	1,087,182,054	785,256,127
Primary Reserve (Notes 7 & 10)	5,784,290,645	5,717,193,461
Secondary Reserve (Note 7)	601,160,638	612,045,000
Total Liabilities and Reserves	$8,347,201,670	$7,536,646,880

*The accompanying notes are an integral part of these financial statements.

FSLIC: Comparative Statement of Income and Expense
for the years ended December 31, 1983 and 1982*

	1983	1982
Income		
Insurance Premiums (Note 7)	$ 336,461,006	$ 436,686,280
Interest on Investments	654,666,966	591,278,444
Interest on Loans to Insured Institutions	20,720,094	33,982,338
Income on Mortgage Loans	26,194,774	24,162,008
Other Income	631,000	1,251,140
Total Income	1,108,473,981	1,077,760,000
Expenses		
Administrative Expenses	1,676,737	1,613,540
Net Loss on Sale of Securities	17,667,001	309,250
Services Rendered by the Federal Home Loan Bank Board (Note 8)	30,276,417	26,046,845
Insurance Settlement and Other Expenses	83,380,983	41,842,674
Provision for Possible Future Losses:		
Contribution Agreements (Note 4)	885,178,263	560,716,814
Mortgage Loans and Other Assets	5,000,000	56,863,388
Certificates	85,400,000	169,800,000
Subrogated Accounts (Net) (Note 3)	108,028,240	-0-
Total Expenses	1,087,647,730	903,111,400
Net Income from Operations	$ 94,825,261	$ 174,628,501
Interest Applied to the Secondary Reserve (Note 7)	47,758,026	50,166,475
Net Income	$ 47,067,235	$ 124,462,026

*The accompanying notes are an integral part of these financial statements.

FSLIC: Comparative Statement of Changes in Financial Position
for the years ended December 31, 1983 and 1982*

	1983	1982
Source of Funds:		
Net Income	$ 47,067,235	$ 124,462,026
Add (Deduct) Items Not Requiring, or Generating Cash:		
Depreciation of Furniture and Equipment	16,280	12,900
Provision for Losses on:		
Mortgage Loans	5,000,000	56,863,388
Certificates	85,400,000	169,800,000
Contributions	885,178,263	560,716,814
Subrogated Accounts	108,000,000	-0-
Return on Secondary Reserve	47,758,026	50,166,475
Transfer from Secondary Reserve	(180,000)	(28,081,577)
Amortization Income	(88,307,010)	(32,066,507)
Funds Provided from Operations	938,832,461	930,427,524
Increase (Decrease) in:		
Notes Payable and Accrued Interest	468,666,414	387,530,427
Accounts Payable and Other Liabilities	7,977,931	(11,296,000)
Decrease in:		
Loans to Insured Institutions and Interest Receivable	134,239,374	43,567,946
Mortgage Loans and Other Assets	109,807,750	43,271,387
Total	$1,660,323,000	$1,393,540,914
Application of Funds:		
Increase in:		
Subrogated Accounts	$ 253,427,602	$ 30,217,908
Income Capital and Net Worth Certificates	423,300,000	357,800,000
Investments and Interest Receivable	313,871,377	503,537,754
Accounts and Dividends Receivable	23,668,880	232,320
Amount Paid Under Contribution Agreements	583,984,339	550,077,673
Refund of Secondary Reserve	57,513	109,619
Total	$1,603,264,257	$1,346,774,480
Increase (Decrease) in Cash	$ 897,681	$ (2,233,[illegible])

*The accompanying notes are an integral part of these financial statements.

FSLIC Notes to Financial Statements (December 31, 1983 and 1982)

1. Summary of significant accounting policies:

a) Investments—Investment securities are stated at cost, adjusted for amortization of premiums and accretion of discounts. Such amortization and accretion are computed on the level yield method at rates based upon the lives of the related securities. Both amortization and accretions are recognized as an adjustment to interest on investments.

b) Furniture and equipment—These assets are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over seven years. The net balance of this account is insignificant and is included in other assets.

c) Income recognition—Insurance premium income is recognized as earned when member institutions are assessed.

d) The 1982 statement of changes in financial position was reclassified to be comparable with the 1983 format.

e) Generally the Provision for Possible Future Losses is recorded when a default prevention action is taken.

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Federal Savings and Loan Insurance Corporation Financial Statements

FSLIC: Comparative Statement of Financial Condition at December 31, 1981 and 1980

Assets, Liabilities, and Reserves	1981	1980
Assets		
Cash	$ 2,438,212	$ 1,919,924
Receivables	22,709,072	18,730,089
Investments at Amortized Cost (Notes 1 and 2)	4,771,332,460	5,050,560,060
Accrued Interest on Investments	98,534,058	91,177,743
Income Capital Certificates (Note 8)	64,000,000	-0-
Assets Acquired from Insured Institutions, Net of Allowance for Possible Future Losses (Notes 3 and 4)	1,611,084,509	1,299,884,326
Loans to Insured Institutions and Accrued Interest, Net (Note 7)	389,960,516	214,774,487
Deferred Charges and Other Assets (Note 1)	104,718	108,284
Subrogated Accounts in Insured Institutions in Liquidation	66,230,832	-0-
Total	$7,037,432,386	$6,546,953,720
Liabilities and Reserves		
Miscellaneous Accrued and Other Liabilities	$ 38,752,432	$ 100,546,058
Notes Payable to Insured Institutions (Note 8)	64,000,000	-0-
Allowance for Possible Future Losses under Contribution Agreements (Notes 5 and 6)	612,510,888	17,538,688
Deferred Credits	819,457	8,611,980
Primary Reserve (Cumulative Net Income)	5,702,284,223	5,670,095,814
Secondary Reserve (Premium Prepayments)	598,261,377	792,172,192
Total (Notes 11 and 12)	$7,037,432,386	$6,546,953,720

FSLIC: Source and Application of Funds Statement for the Years Ended December 31, 1981 and 1980

Funds Provided By:	1981	1980
Net Income	$32,188,409	$779,112,294
Adjust for Items Not Affecting Working Capital:		
Depreciation of Furniture, Fixtures, and Equipment and Amortization of Leasehold Improvements	13,729	33,046
Adjustment to Provisions for Losses on:		
Assets Acquired from Insured Institutions	10,120,000	-0-
Estimated Future Contributions to Insured Institutions	861,991,879	15,084,140
Return on Secondary Reserve	55,457,653	67,562,440
Transfers from Secondary Reserve to Pay Insurance Premiums	(117,574,918)	(112,701,768)
Amortization Income	(1,753,812)	(4,237,919)
Subtotal	$840,842,742	$744,852,233
Realization on Assets Acquired from Insured Institutions:		
Principal Payments on Mortgage Loans	58,066,192	16,838,044
Principal Payments on Contracts and Other Assets	67,430,411	22,754,836
Cash Sales of Real Estate and Other Assets	1,388,522	148,183
Adjustment to Allowance for Loss Accounts for Prior Year Items	18,082	17,937
Subtotal	$125,519,208	$39,759,000
Excess Book Value over Cost	-0-	16,367,319
Issuance of Notes Payable to Insured Institutions (Note 8)	64,000,000	-0-
Principal Payments on Loans to Insured Institutions	23,026,117	4,618,848
Reduction in Securities (Note 10)	299,867,000	635,491,000
Decrease in Working Capital	-0-	84,729,134
Principal Payment on Notes and Advance Contributions	2,121,500	721,025
Total Funds Provided	$1,366,366,578	$1,526,538,559

FSLIC: Comparative Statement of Income, Expense, and Primary Reserve for the Years Ended December 31, 1981 and 1980

Income, Expenses, and Primary Reserve	1981	1980
Income		
Examination Fees and Charges (Note 6)	$ -0-	$ 13,428,247
Insurance Premiums (Note 1)	425,070,211	399,102,582
Interest on Investments	409,244,007	435,218,738
Interest on Loans to Insured Institutions	32,778,019	10,439,951
Income on Assets Acquired from Insured Institutions	144,428,122	53,788,246
Interest Income on Notes Receivable and Advanced Contributions	638,798	650,374
Miscellaneous Income	4,420	612,200
Nonoperating Income	84,053	28,335,312
Total Income	$1,012,238,630	$941,562,625
Expenses		
Administrative:		
Department of Examinations—Home Office	$ -0-	$ 908,922
Department of Examinations—Field	-0-	23,709,609
Subtotal Department of Examinations (Note 6)	$ -0-	$24,618,531
Department of Insurance	989,691	853,533
Total Administrative	$989,691	$25,472,064
Loss on Sale of Securities	8,641,009	28,316,008
Services Rendered by Federal Home Loan Bank Board	29,884,738	16,828,681
Insurance Settlement and Other Expenses	10,094,400	8,090,201
Unallocated Nonadministrative Expense	2,461,090	1,118,847
Net Provision for Possible Future Losses (Notes 4 and 5)	872,511,879	15,084,140
Interest Applied to Members' Equity in Secondary Reserve	55,457,653	67,562,440
Total Expenses	$980,050,221	$162,450,331
Primary Reserve		
Net Income Transferred to Primary Reserve	32,188,409	779,112,294
Balance, Beginning of Year	5,670,095,814	4,890,983,520
Balance, End of Year	$5,702,284,223	$5,670,095,814

FSLIC: Source and Application of Funds Statement for the Years Ended December 31, 1981 and 1980—Continued

Funds Applied To:	1981	1980
Acquisition of Assets:		
Subrogated Accounts in Insured Institutions in Liquidation	$ 66,230,832	$ -0-
ICCs Acquired from Insured Institutions (Note 8)	64,000,000	-0-
Assets Purchased from Insured Institutions	520,528,441	1,198,122,133
Capitalized Expenditures on Assets Acquired from Insured Institutions	34,796,132	17,363,546
Furniture, Fixtures, and Equipment and Leasehold Improvements	3,828	(141,159)
Loans to Insured Institutions	199,337,387	148,574,516
Contributions to Insured Institutions	387,003,461	41,989,879
Refund of Secondary Reserve	130,793,563	118,515,561
Increase in Cash	516,287	1,310,846
Increase in Working Capital	70,160,086	-0-
Total Funds Applied	$1,366,366,578	$1,526,538,559

The statements for 1980 are unaudited.

FEDERAL HOME LOAN BANK SYSTEM

The FHLBanks are instrumentalities of the United States that were organized under the authority of the Federal Home Loan Bank Act (the "Act") (12 U.S. Code 1421 *et seq.*). Under the Act, twelve geographic districts have been created, and each FHLBank furnishes reserve banking facilities in its district to members and nonmember borrowers. While each FHLBank has its own management, employees and board of directors, all are subject to the rules, regulations and orders of and are supervised by the Board. Any federal or state building and loan association, savings and loan association, cooperative bank, homestead association or savings bank or any insurance company which is subject to inspection and regulation under the banking laws or similar laws of a state or the United States and which makes long-term home mortgage loans is eligible to be a member or a nonmember borrower of a FHLBank (unless denied eligibility by the Board). Entities of this nature (except insurance companies) are sometimes referred to as "thrift institutions".

The Federal Home Loan Bank System (the "Bank System") is comprised of the Board, the twelve FHLBanks, member thrift institutions and member life insurance companies. In addition, the Bank System includes the Federal Savings and Loan Insurance Corporation ("FSLIC"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and the Neighborhood Reinvestment Corporation ("NRC").

FSLIC is an agency of the U.S. government which insures deposit accounts in member institutions up to a maximum of $100,000 per individual account. Freddie Mac was established by statute in 1970 to effect a secondary market for conventional home mortgages, thereby providing an additional source of funds to home mortgage lenders. Since its inception, Freddie Mac has been a major participant in the secondary mortgage market. The NRC was established in 1978 to encourage neighborhood revitalization by mobilising public, private and community resources at the neighborhood level, relying largely on local initiative for the specific design of local housing programs.

In addition to governing and regulating the FHLBanks, the Board regulates all federally chartered thrift institutions and shares with the states regulatory authority over state chartered thrift institutions whose deposits are insured by FSLIC.

The purpose of the Bank System is the achievement of sound mortgage credit and a more stable supply of mortgage credit. It does so in part by maintaining funds that are available to the thrift industry for liquidity and for home mortgage lending. A primary function of the FHLBanks is to lend funds in the form of advances to member thrift institutions for mortgage lending by the members and for members' general corporate purposes. The sale of debt obligations is the principal source of funds for the FHLBanks. Traditionally, these obligations have been in the form of consolidated bonds, issued monthly, to meet long-term funding requirements, and discount notes, issued daily, to provide for short-term variations in cash needs. The consolidated debt instruments of the FHLBanks, like the Bonds offered hereby, are the joint and several obligations of all of the FHLBanks.

CAPITALIZATION

The following table sets forth the combined capitalization of the FHLBanks at September 30, 1984, and as adjusted for the issuance of the Bonds offered hereby.

	Actual	As Adjusted(1)
	(In Millions)	
Consolidated obligations		
Due within one year		
Discount notes (at par)	$15,919	$15,919
Bonds	17,735	17,735
Less passthroughs(2)	(600)	(600)
Net bonds	17,135	17,135
Total due within one year	33,054	33,054
Due after one year		
Bonds	34,300	34,300
Less passthroughs(2)	(1,190)	(1,190)
Net bonds	33,110	33,110
Bonds offered hereby	—	200
Total due after one year	33,110	33,310
Total bonds and discount notes(3)	$66,164	$66,364
Capital		
Capital stock outstanding	$ 6,940	$ 6,940
Retained earnings		
Legal reserve	1,147	1,147
Dividend stabilization reserve	177	177
Undivided profits	324	324
Total retained earnings	1,648	1,648
Total capital	$ 8,588	$ 8,588

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(1) The FHLBanks typically issue consolidated bonds monthly and discount notes daily. No adjustments have been made for issuances subsequent to September 30, 1984.

(2) Proceeds from certain consolidated obligations have been advanced to Freddie Mac at the same interest rates and maturities as the related obligations. Accordingly, the advances and the related consolidated obligations have been offset.

(3) Total consolidated obligations, as shown herein, do not reflect a deferred net loss from hedging transactions of $548 thousand.

SELECTED FINANCIAL DATA

The following financial data for the years 1979 through 1983 and the nine months ended September 30, 1983 and 1984 have been selected from the unaudited combined financial statements of the FHLBanks. The combined financial statements were compiled from the twelve separate FHLBank statements. Transactions between FHLBanks have not been eliminated but are not considered material. The selected data should be read in conjunction with the combined financial statements and notes to combined financial statements which are presented elsewhere herein and with the explanatory statement under the caption "Financial Statements."

Statement of Income Data

(In Millions)

	Year Ended December 31,					Nine Months Ended September 30,	
	1983	1982	1981	1980	1979	1984	1983
Interest and fees on advances to members	$6,754	$8,708	$6,994	$4,481	$3,225	$5,373	$5,115
Income from investments	1,297	1,286	943	622	482	930	960
Total income	8,470	10,084	7,999	5,154	3,738	6,625	6,402
Total interest and other costs	7,616	9,026	7,384	4,681	3,154	5,911	5,755
Total expenses	7,739	9,122	7,464	4,738	3,200	6,021	5,844
Net income	731	962	535	417	538	604	558

Statement of Condition Data

(In Millions)

	As of December 31,					As of September 30,	
	1983	1982	1981	1980	1979	1984	1983
Advances to members	$58,979	$66,007	$65,194	$48,963	$41,838	$73,005	$57,862
Total assets	72,490	80,268	74,680	54,347	46,428	92,633	73,276
Total deposits and borrowings	14,158	15,162	12,185	10,147	9,368	16,759	14,815
Consolidated obligations	48,931	55,967	54,131	37,268	30,372	65,616	49,283
Total liabilities	64,756	72,855	67,880	48,318	40,336	84,045	65,557
Total capital	7,734	7,414	6,801	6,029	6,092	8,588	7,718

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL RESULTS

Results of Operations

Nine Months Ended September 30, 1983 and 1984

The increase of 3.5% in total income and 8.2% in net income for the nine months ended September 30, 1984 over the comparable 1983 period resulted from a higher level of advance activity. In contrast to the declining advance activity the FHLBanks experienced in the first nine months of 1983, advances increased rapidly from January 1, 1984 to September 30, 1984. While invested funds were greater in the 1984 period than in the 1983 period, income from investments declined slightly due to lower interest rates earned on the portfolio. The 3% increase in total expenses for the 1984 period over the 1983 period was consistent with the increased advance activity.

The majority of the growth in advances occurred from April 1984 through September 1984, strongly influenced by rising interest rates in the second quarter and an active adjustable rate mortgage market. In keeping with the high levels of activity in the adjustable rate mortgage market, the FHLBanks increased their variable rate advances to members as a percentage of their total advances portfolio. Since the end of September 1984, advances have remained relatively flat. Borrowing for the housing market is typically stronger during the spring and summer months.

1981, 1982 and 1983

The increase in income from advances to members and in net income in 1982 over 1981 resulted from a higher average level of outstanding advances and a greater proportion of longer term advances bearing higher interest rates than short-term advances. Repayments in advances in 1983 were the primary cause of lower interest on advances and net income from 1982 levels. Total interest and other costs were greater in 1982 versus 1981 or 1983, in part due to higher amounts of consolidated bonds outstanding and the increased financing undertaken at high interest rates. The effect in 1983 was partially offset by higher prevailing interest rates.

Liquidity and Capital Resources

Growth in advances during the first nine months of 1984 was supported by increases in FHLBanks' consolidated obligations. Consolidated obligations outstanding as of September 30, 1984 represented a net increase of approximately $16.7 billion from the amount outstanding as of December 31, 1983.

Deposits increased during the first nine months of 1984. FHLBanks from time to time encourage increases in deposits in anticipation of increases in advances demand. In 1984, increases also resulted from member institutions' concerns regarding the quality and safety of their short-term investments. Most of the deposit growth occurred in the overnight deposits programs, against which FHLBanks held overnight assets.

In anticipation of potential acceleration of FHLBanks' advance activity and declining liquidity in the thrift industry, and also to allow for contingencies, the FHLBanks increased their own liquidity throughout the nine-month period ending September 30, 1984. Market prepayment penalties on advances to members were instituted in 1982 and continue to prevail. These penalties are based on market interest rates prevailing at the time of prepayment, so that prepayment of a loan at a time when a new loan would be made at a lower rate will not adversely affect the FHLBanks. System wide, interest rate sensitivity has declined in importance as the FHLBanks have attained a condition of substantially matched assets and liabilities. The matching of assets to liabilities is expected to continue in the foreseeable future. In February 1984, in order to supplement the existing risk management tools and to enable the FHLBanks to reduce further interest rate risk exposure, the Board also authorised the FHLBanks to engage in interest rate swaps for their own asset/liability management and to assist member institutions in interest rate risk management.

Recent Development

On December 7, 1984, Freddie Mac declared a distribution of a special dividend to the FHLBanks of shares of a participating preferred stock of Freddie Mac; the FHLBanks in turn will pay a stock dividend in such shares of preferred stock to their member institutions of record as of December 31, 1984. Since the FHLBanks currently own all the outstanding capital stock of Freddie Mac, the transactions will have the effect of transferring a substantial portion of the appreciated value of the capital stock of Freddie Mac from the FHLBanks to their member institutions. The preferred stock will be entitled to annual dividends of an aggregate of $10 million plus an amount equal to nine times the amount of any dividend paid on the common stock of Freddie Mac. Since it is expected that the FHLBanks will hold all of the common stock of Freddie Mac and will hold none of the preferred stock, the FHLBanks will receive substantially lower dividends from Freddie Mac in the future than they otherwise would have received had such transactions not occurred. For the years ended December 31, 1981, 1982 and 1983, net income of the FHLBanks included dividends from Freddie Mac of $2 million, $14 million and $34.5 million, respectively.

BUSINESS

The Bank System was established in 1932 under the Act to provide a central credit facility for thrift institutions and insurance companies engaged in long-term home lending. The purpose of the Act was to create a system which would foster sound mortgage credit and a more stable supply of mortgage credit.

The FHLBanks each serve the thrift institutions located within a district, and the twelve districts cover all of the United States, Puerto Rico, the Virgin Islands and Guam. The FHLBanks are located in Boston, New York City, Pittsburgh, Atlanta, Cincinnati, Indianapolis, Chicago, Des Moines, Dallas, Topeka, San Francisco and Seattle. The thrift institution members are the owners of all of the FHLBanks' capital stock.

In their primary role as a central source of credit, the FHLBanks perform two major functions. First, they extend credit to members in the form of loans, called "advances." Second, they accept various types of deposits from their members. While FHLBank funds are used principally for making advances to member institutions, an important use of FHLBank funds is the maintenance of cash and investments, or liquidity, sufficient to provide stability to the thrift industry and to meet large or unexpected demands for advances. The principal sources of funds used in the FHLBanks' operations are the sale of consolidated debt obligations, the repayment of advances, and member deposits. To a lesser degree, the sale of capital stock and earnings from operations also provide funds.

The FHLBanks also provide a number of related services, such as the purchase, sale and safekeeping of securities on behalf of and at the direction of their members. Most provide member institutions with certain account collection, processing and settlement services. In addition, they provide statistical and economic research relating to the financial conditions of their districts. Each FHLBank is subject to the rules, regulations and orders of the Board.

Advances

Advances to member institutions represent the largest category of the FHLBanks' assets. Each FHLBank develops its own advances programs, within broad guidelines established by the Board, to meet the particular needs of its members. Together the FHLBanks provide a source of liquidity to the Bank System. A flexible advances policy has helped to satisfy the short-term and long-term goals of the Bank System by performing several important functions. For example, when interest rates paid by thrift institutions to their depositors were regulated, advances by the FHLBanks were used to moderate the effect of member deposit outflows in periods of high interest rates. Advances have also provided members with a supplementary source of funds for expansion and have smoothed seasonal imbalances in savings receipts and mortgage loan disbursements. On a larger scale, the use of advances has frequently prevented imbalances within the Bank System by shifting funds from geographical areas of surplus to areas of need. Advances, moreover, have provided the Board a means of carrying out policy regarding housing and the thrift industry.

Under the Act, each FHLBank is authorised to make secured advances to its members upon such security as the Board may prescribe. The amount a member may borrow is limited by the laws under which the member operates. In addition, the aggregate advances from a FHLBank to a member may not exceed 20 times the amounts paid by the member for capital stock of the FHLBank it holds.

All advances with maturities of more than five years must be secured by collateral. Under current Board regulations, eligible collateral for advances with a maturity longer than five years can consist of any property which is an authorised investment for the member institution and which falls within one of the following categories: (1) fully disbursed, whole first mortgages on improved residential property, not more than 90 days delinquent; (2) securities issued, insured or guaranteed by the United States government or any agency thereof (including, without limitation, mortgage-backed securities issued or guaranteed by Freddie Mac, the Federal National Mortgage Association and the Government National Mortgage Association); (3) deposits in a FHLBank; or (4) property which is acceptable to the FHLBank, provided that the FHLBank determines that such property has a readily ascertainable value and the FHLBank is able to perfect a security interest in such property.

Although the FHLBanks are permitted to make unsecured advances for five years or less, the majority of all advances made are secured, with mortgage loans representing the principal form of collateral. Unsecured advances must be approved by the FHLBank's executive committee, a majority of its directors, or two of its officers. Except with the prior approval of the Board, the aggregate unpaid principal amount of advances to a member with an unexpired maturity of more than 30 days (not covered by the requirements outlined above for advances with a maturity longer than five years) may not exceed five percent of the member's withdrawable accounts.

As additional security for any indebtedness of a member to it, a FHLBank has a statutory lien upon the member's FHLBank stock. Each FHLBank also has the statutory right at any time to require deposits of additional collateral security or substitutions of security by the borrowing institution.

A FHLBank may also make advances to federally approved, non-member mortgagees upon the security of certain federally insured mortgages. While such advances are not subject to the other provisions and restrictions of the Act, they must be at such rates of interest and on such terms and conditions as are determined by the Board and may be made only to certain chartered institutions which are subject to the inspection and supervision of a governmental agency, and whose principal activity in the mortgage field consists of lending their own funds.

Each FHLBank maintains considerable discretion in managing its own programs within broad guidelines imposed by the Board. Credit, liquidity and interest rate risk management play an important role in each FHLBank's advances programs. The FHLBanks retain discretion to ration available funds among members, but have the responsibility to foster sound asset/liability management on the part of the borrowing members. The current Board policy with respect to advances primarily addresses pricing, maturity, and risk management and includes the following: (1) all FHLBanks will offer a range of fixed or amortised advances with maturities up to ten years, and advances with maturities up to twenty years may be offered; (2) interest rates on advances should reflect actual conditions existing in the credit markets and generally conform to a suggested schedule of markup ranges; (3) advances may be rationed by price; (4) prepayments on advances will carry a fee sufficient to make the FHLBank financially indifferent to the borrower's decision to prepay advances; and (5) FHLBanks may make commitments for advances, fees for which should reflect the risks and cost of the FHLBank in making the commitment.

Currently, FHLBanks offer both short term, variable-rate and longer term, fixed-rate advances. Prepayment privileges and fees differ among the FHLBanks. Whereas in most cases no prepayment penalties are imposed in connection with variable-rate advances, the lending FHLBank commonly imposes a penalty on the borrowing member for a fixed rate advance repaid prior to maturity.

The FHLBanks may make commitments for advances to a member covering a predefined time period. This program is designed to aid the members and FHLBanks in their cash flow planning and enables member institutions to shift some risks of funding to the FHLBanks. The FHLBanks require commitments from their members for advances with maturities of twelve months or longer.

Member Deposits

As authorised in the Act, each of the twelve FHLBanks may accept deposits from its member institutions and from non-member institutions that are eligible for membership. Deposit programs provide a significant portion of the FHLBanks' financial resources, while also giving participating institutions a place for holding liquid assets and a means to satisfy the liquidity requirements imposed on them by the Board. Deposits received by the FHLBanks to fund advances help redistribute funds from members in areas of surplus to members in areas of need. The FHLBanks generally offer four types of deposits to members: demand, overnight, term and special series.

Demand or Transaction Deposits. Each FHLBank accepts in some form checking account deposits, which may or may not be interest bearing, that have no withdrawal penalties. Many members use their demand accounts for processing savings withdrawals and mortgage loan disbursements and to pay the FHLBanks for securities transactions performed on their behalf.

Overnight Deposits. Deposits made by member institutions in a FHLBank are placed in overnight deposit accounts in order to earn daily interest. The funds in these accounts have represented the largest portion of members' deposits since late 1974. While many FHLBanks change the interest rate paid on outstanding balances daily, several have at times specified the rate over a longer period. The overnight deposit program gives member institutions an opportunity to sell funds to their FHLBanks in a method similar to the sale of federal funds by commercial banks. The program provides a facility for investing short-term funds that at one time might have been left idle while a longer-term investment was being selected.

Term Deposits. Most FHLBanks offer certificates of deposit at competitive market rates for periods of one month to one and one-half years. At the option of the FHLBank, the certificates may be either nonredeemable prior to maturity or subject to an interest penalty if surrendered before their due date.

Special Series Deposits. Introduced in 1973, this deposit program was designed to retain funds within the Bank System and to smooth imbalances in the supply of and demand for capital among districts. The process involves the funding of one or more advances specifically with deposits from one or more members. These deposits are not redeemable prior to maturity, which may be as brief as one day or as long as one year.

For the safety of member deposits, each FHLBank is required to have at all times an amount equal to the current deposits of its members invested in obligations of the United States, deposits in banks or trust companies, advances with a maturity not to exceed five years and unsecured advances to borrowers whose creditor liabilities (not including advances from the FHLBank) do not exceed five percent of their net assets.

Financing—Consolidated Obligations

The primary source of funds for the FHLBanks is the sale and issuance of consolidated obligations in the capital markets. The obligations of the FHLBanks are secured solely by the credit of the twelve FHLBanks and are neither direct nor indirect liabilities of the United States.

Consolidated obligations are issued by the Board under the authority of the Act, which expressly authorises the issuance of consolidated bonds which are the joint and several obligations of all the FHLBanks. The following limitations and conditions are imposed by Board regulations which by their terms may not be revoked or relaxed until all outstanding consolidated obligations are retired and provision for full payment thereof has been made:

(1) Consolidated bonds may not be issued in an aggregate amount in excess of twelve times the total paid-in capital stock and reserves of all the FHLBanks; and

(2) The FHLBanks must at all times maintain, in a total amount at least equal to the amount of consolidated bonds outstanding, the following types of assets free from any lien or pledge: (a) cash; (b) obligations of or fully guaranteed by the United States; (c) secured advances; and (d) mortgages as to which one or more FHLBanks have any guaranty or insurance, or commitment thereof, by the United States or any agency of the United States.

Consolidated bonds issued with maturities of one year or less may be designated "consolidated notes." While the majority of consolidated debt is obtained through monthly bond offerings and daily discount note sales, the FHLBanks and the Board may avail themselves of other types of financing.

Consolidated Bonds. FHLBank bonds are issued to satisfy long-term funding requirements. Typically, the maturity of these securities is from six months to ten years, but no statutory or regulatory limit exists, and the longest issue to date has been twenty years. The consolidated bonds may be issued during any month when funds are needed, subject to approval of the U.S. Department of the Treasury. The sizes of the monthly consolidated bond offerings vary according to the needs of the Bank System.

Consolidated Discount Notes. The FHLBanks also sell and issue consolidated discount notes to provide short-term funds for seasonal and cyclical fluctuations in savings flows and mortgage financing. Such discount notes also have been used as bridge financing tools and as a source of funds for variable-rate advances. These securities have maturities of up to one year and are sold daily. Daily discount note issuances range from $25 million to $500 million.

Reserves, Investments and Dividends

Reserves. Each FHLBank is required to carry to a reserve account (the "legal reserve account") semiannually 20 percent of its net earnings until the legal reserve account shows a credit balance equal to the paid-in capital of the FHLBank, and thereafter five percent of its net earnings must be added semiannually to the legal reserve account. This requirement can be suspended at the option of the Board. See Note 9 to the Combined Financial Statements. Each FHLBank is also required to establish such additional reserves and/or make such charge-offs on account of depreciation or impairment of its assets as the Board may require from time to time.

Investments. The Act also specifies that the reserves of each FHLBank are required to be invested, subject to such regulations, restrictions, and limitations as may be imposed by the Board, in direct obligations of the United States, in obligations, participations, or other instruments of or issued by the Federal National Mortgage Association or the Government National Mortgage Association, in mortgages, obligations, or other securities which are or were sold by Freddie Mac, and in such securities as fiduciary and trust funds may be invested in under the laws of the state in which the FHLBank is located.

Assets in excess of those required to be held against deposits or for reserves may be invested, to the extent the FHLBank deems desirable and subject to the regulations, restrictions and limitations imposed by the Board, in the investments described in the preceding paragraph as well as in other obligations of the United States or of its agencies, if the U.S. Attorney General has determined that the obligations are those of the United States, in the stock of the Federal National Mortgage Association and in stock, obligations, or other securities of any small business investment company formed pursuant to Section 301(d) of the Small Business Investment Act of 1958 for the purpose of aiding members of the Bank System.

Dividends. The FHLBanks pay dividends out of net earnings remaining after all reserves and charge-offs required under the Act have been provided for and out of their dividend stabilization reserves, subject to the approval of the Board.

Risk Management

Beginning in 1982, the Board expanded the FHLBanks' risk management capability, so that now FHLBanks are permitted to use financial futures, cash market instruments and options on debt instruments and futures for use in advances pricing and the hedging of interest rate risk incurred in the normal course of business.

The Board also authorises the FHLBanks to enter into interest rate swaps to reduce or manage both their own and member interest rate risks. The FHLBanks may engage in swaps as principal with their members directly or as agent between members and other parties, and also may provide standby letters of credit on behalf of members for swaps between members and other parties.

Statutory Regulation and Government Supervision

The Government Corporation Control Act requires that all issues of FHLBank consolidated obligations be approved by the Secretary of the Treasury. The Federal Home Loan Bank Act authorises the Secretary of the Treasury in his discretion to purchase any obligations issued by the FHLBanks up to an aggregate principal amount of $4 billion. No borrowings under this authority have been outstanding since 1977. The U.S. Department of the Treasury receives the Board's annual report to Congress, monthly reports reflecting securities transactions of the FHLBanks and other quarterly and annual reports reflecting the operations of the FHLBanks.

The financial statements of the twelve FHLBanks are subject to audit by several different entities. These include independent certified public accounting firms, the U.S. General Accounting Office and the Board's Internal Evaluation and Compliance Office. The Government Corporation Control Act requires the U.S. General Accounting Office to audit the FHLBanks at least once every three years. The audit is conducted on a calendar year basis and is effected in accordance with the principles and procedures applicable to commercial corporate transactions and under such rules and regulations as may be prescribed by the Comptroller General of the United States. As permitted by the Government Corporation Control Act, representatives of the General Accounting Office have confined their activities largely to periodic surveys of the operations of the FHLBanks and analyses of examinations and audit reports made by the Board's Internal Evaluation and Compliance Office.

Selected FHLBank Financial Data

The following table sets forth selected statement of income data for each FHLBank for the two years ended December 31, 1983 and 1982 and statement of condition data as of December 31, 1982 and 1983. The data were taken from the FHLBanks' separate audited financial statements. See "Financial Statements."

(Dollars in Millions)

	I Boston	II New York	III Pittsburgh	IV Atlanta	V Cincinnati	VI Indianapolis	VII Chicago	VIII Des Moines	IX Dallas	X Topeka	XI San Francisco	XII Seattle
1983												
Statement of Income Data												
Interest and fees on advances to members	163	637	164	842	379	387	356	428	434	403	1,911	650
Income from investments	53	55	81	190	146	34	120	36	168	40	254	120
Total income	220	744	259	1,056	536	435	485	480	643	458	2,362	793
Total interest and other costs	195	640	234	940	484	374	408	416	544	415	2,253	713
Total expenses	198	654	240	951	496	380	416	428	558	419	2,281	718
Net income	21	90	20	105	40	55	69	52	85	40	78	76
Statement of Condition Data												
Advances to members	1,350	5,552	1,401	7,255	3,284	3,751	2,766	3,097	3,814	3,588	17,583	5,538
Total assets	1,944	6,321	2,070	8,481	4,587	4,294	4,093	3,549	5,943	3,934	20,601	6,673
Total deposits and borrowings	388	867	602	1,880	1,148	919	1,458	919	1,781	544	2,609	1,043
Consolidated obligations	1,227	4,329	1,160	5,303	2,830	2,901	1,947	2,146	3,433	2,935	15,715	5,004
Total liabilities	1,648	5,326	1,798	7,373	4,057	3,898	3,489	3,122	5,343	3,574	18,925	6,202
Total capital	296	995	272	1,108	530	396	603	427	600	360	1,676	471
1982												
Statement of Income Data												
Interest and fees on advances to members	157	826	237	1,228	518	276	480	482	566	456	2,791	691
Income from investments	46	107	56	164	123	29	90	46	126	47	323	129
Total income	207	949	291	1,396	647	310	573	534	701	508	3,140	828
Total interest and other costs	187	847	259	1,240	566	274	491	480	595	455	2,878	754
Total expenses	190	859	264	1,250	576	279	497	488	604	458	2,899	758
Net income	17	90	27	147	70	31	75	46	98	50	241	70
Statement of Condition Data												
Advances to members	1,475	5,801	1,662	8,710	3,807	2,764	3,520	4,205	3,994	3,575	20,586	5,908
Total assets	2,040	6,687	2,692	10,892	5,240	3,055	4,308	4,747	5,089	4,137	23,965	7,416
Total deposits and borrowings	491	783	901	2,755	1,322	594	1,129	1,020	1,035	455	3,262	1,415
Consolidated obligations	1,248	4,844	1,467	6,826	3,291	2,087	2,511	3,242	3,417	3,247	18,338	5,449
Total liabilities	1,774	5,783	2,411	9,791	4,713	2,737	3,723	4,343	4,557	3,806	22,228	6,988
Total capital	266	904	281	1,101	527	318	586	404	532	330	1,737	428

The Board

The Board, as an independent agency of the United States government, has supervisory and regulatory control over the FHLBanks. The Board determines the eligibility of FHLBank members in accordance with criteria contained in the Act and has authority to promulgate rules and regulations and to enact orders necessary for carrying out that Act. The Act requires that annual reports be made to Congress and that the Board require examinations and reports of condition of the FHLBanks.

Although Congress and the General Accounting Office review its annual expenditures, the Board is self supporting. Its operating costs are paid by assessments levied on the twelve FHLBanks and on FSLIC and hence are borne indirectly by member thrift institutions.

FSLIC

FSLIC was established in 1934 by the National Housing Act to perform for the thrift industry the function that the Federal Deposit Insurance Corporation ("FDIC") performs for commercial banks. The purpose of the National Housing Act was to establish an entity whose function it was to insure savings accounts in thrift institutions and to prevent default of an insured institution. The creation of both the FDIC and FSLIC was a response to the massive number of bank and thrift failures in the early 1930s. All deposit accounts in FSLIC's member institutions are insured by FSLIC against losses up to $100,000 per individual account.

FSLIC was initially capitalized by the Federal government's contribution of $100 million. Ownership was subsequently transferred to the U.S. Department of the Treasury. Between 1950 and 1958, FSLIC completely repurchased its stock from the U.S. Department of the Treasury. FSLIC income is provided by premiums paid by member institutions and interest earned on invested funds. FSLIC insurance is mandatory for federally chartered thrift institutions. Many of the state chartered savings and loan institutions are also required by their chartering authorities to carry FSLIC insurance.

As an insurer, FSLIC maintains liability reserves. In addition, it is authorised to borrow from the U.S. Treasury, and the Secretary of the Treasury is authorised and directed to lend to FSLIC, amounts up to $750 million if the Board decides that a loan or loans are required for insurance purposes. No such loan is currently outstanding. Furthermore, Congress passed a non-binding resolution in 1982, reaffirming that FSLIC insured deposits are backed by the full faith and credit of the United States up to the prescribed limit.

FSLIC attempts to preserve the insurance fund by preventing defaults by insured institutions. It has the authority to arrange mergers, acquire assets, make loans and provide capital to avert liquidations.

MANAGEMENT

The Board

Each FHLBank is managed under the supervision of the Board and by a FHLBank board of directors. The Board establishes broad guidelines within which the FHLBanks operate as decentralized entities. The Board is composed of three members, appointed by the President of the United States and confirmed by the Senate to fill four-year terms. One member is designated by the President as Chairman, and no more than two members may belong to the same political party. The current members of the Board are Edwin J. Gray, Chairman, Mary A. Grigsby and Donald I. Hovde.

Mr. Gray has been a member of the Board since March 24, 1983 and its Chairman since May 1, 1983. From 1973 to 1981, Mr. Gray was a senior executive at San Diego Federal Savings and Loan Association in San Diego, California. Then, in January 1981, he became a Deputy Assistant to the President of the United States and Director of the White House Office of Policy Development. From August 15, 1982 until his appointment to the Board, Mr. Gray was First Vice President and Manager of the Executive Affairs Group of Great American Federal Savings and Loan Association, San Diego, California.

Mrs. Grigsby was appointed to the Board in February 1984. Prior to June 1983, Mrs. Grigsby was Chairman of Houston First American Savings in Houston, Texas, and from June 1983 to February 1984, she was Vice Chairman of United Savings of Houston. Mrs. Grigsby has also served as a director of the FHLBank of Dallas and as a member of the Thrift Advisory Council of the Federal Reserve Board.

Mr. Hovde became a member of the Board in June 1983. From March 1981 to June 1983, Mr. Hovde was Under Secretary of the U.S. Department of Housing and Urban Development and was responsible for the Department's day-to-day operations. Prior to 1981, Mr. Hovde was a commercial and industrial real estate broker and developer in Madison, Wisconsin.

Bank Management

Each FHLBank is managed by a board of directors. Most of the directors are elected by the member institutions to two year terms and the remainder of the directors are appointed by the Board to four year terms. The board of directors of each FHLBank is responsible for monitoring the FHLBank's compliance with Bank System regulations and for establishing policies and programs without discrimination against any member institution. The boards of directors adopt and review policies governing advances, set parameters for interest rates on deposits, and review operating policies. The directors are also responsible for the adoption of credit policies to properly manage the FHLBank's exposure to credit, liquidity and interest rate risk. Board approval is required for adopting a FHLBank's annual budget, selecting the FHLBank president and other FHLBank officers and for setting a dividend rate.

Each FHLBank president is responsible to both the FHLBank's board of directors and the Board. In his responsibility to the Board, the FHLBank president is concerned with adoption and execution of federal laws and the policies, programs, objectives and regulations of the Board. He is also the Board's principal supervisory agent for his district, and, as such, is responsible for assuring that each member institution in his district complies with applicable Board regulations and laws. Each FHLBank president participates in regular strategy and policy meetings with the other FHLBank presidents, the Board, and various other Bank System representatives.

The presidents of the FHLBanks and the territory of each FHLBank are as follows:

FHLBank	President	Territory
Boston	Raymond H. Elliot	Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont
New York	Bryce Curry	New Jersey, New York, Puerto Rico, Virgin Islands
Pittsburgh	Eugene M. Calnan	Delaware, Pennsylvania, West Virginia
Atlanta	Carl O. Kamp, Jr.	Alabama, District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia
Cincinnati	Charles L. Thiemann	Kentucky, Ohio, Tennessee
Indianapolis	Ronald R. Morphew	Indiana, Michigan
Chicago	Leo B. Blaber	Illinois, Wisconsin
Des Moines	Donald F. Roby	Iowa, Minnesota, Missouri, North Dakota, South Dakota
Dallas	Roy Green	Arkansas, Louisiana, Mississippi, New Mexico, Texas
Topeka	Kermit L. Mowbray	Colorado, Kansas, Nebraska, Oklahoma
San Francisco	James M. Cirona	Arizona, California, Nevada
Seattle	James R. Faulstich	Alaska, Guam, Hawaii, Idaho, Montana, Oregon, Utah, Washington, Wyoming

Chairman **St Germain**. Now, we will hear from Mr. Riley on behalf of the National Credit Union Administration.

STATEMENT OF D. MICHAEL RILEY, NATIONAL CREDIT UNION ADMINISTRATION, DIRECTOR, OFFICE OF PROGRAMS, NATIONAL CREDIT UNION SHARE INSURANCE FUND

Mr. **Riley**. Mr. Chairman and members of the subcommittee, I appreciate the opportunity, on behalf of the National Credit Union Administration, to provide you with an update on the National Credit Union share insurance fund.

During the past year, the share insurance fund has experienced the most significant development since its establishment in 1971. On January 21 of this year, the fund received approximately $760 million from insured credit unions as a deposit in their insurance fund.

This action, quadrupling the size of the fund, was the direct result of Congress' passage last year of title VIII of Public Law 98-369.

This new statute provides for strengthening of the fund through the placement of a deposit by each insured credit union in an amount equaling 1 percent of the credit union's insured shares.

The legislation accomplishes the objective of a strong and viable fund solely through the financial support of insured credit unions; that is, through their 1-percent deposit. The deposit of each credit union will be adjusted for growth annually in accordance with changes in the credit union's insured shares.

The NCUA Board projects that, in the absence of extraordinary expenses, the annual earnings on fund assets will be sufficient to meet the expenses of the Fund, and also to allow a waiver or rebate of each credit union's annual insurance premium as well as the declaration of dividend on fund equity.

In practice, this year, we waived the insurance premium and will pay a 5- to 6-percent dividend on deposits. I might add that our equity to insured shares rates is at an all-time high of 1.35 percent.

Finally, we are very proud that, in a first for a Federal Deposit Insurance Fund, the fund received an unqualified, or "clean" opinion on its 1984 financial statements from a big eight accounting firm, Ernst & Whitney, the Fund's outside auditor.

A clean opinion means that in Ernst & Whitney's judgment, the Fund's financial statements, taken as a whole, are presented fairly in accordance with generally accepted accounting principles.

This includes the establishment of adequate reserves to cover all losses which the Fund might reasonably be expected to experience from the problem credit unions it currently insures. We also anticipate an unqualified opinion this year.

As I outlined in greater detail at yesterday's hearing, statistics for the first half of 1985 indicate continued strong growth and performance for credit unions. Savings in Federal credit unions grew substantially, and strong gains were also made in loans, assets and new members during the first 6 months of 1985. Equally important because of its impact on our insurance fund, reserves in Federal credit unions grew at a 20-percent rate.

Finally, the number of problem code Federal and federally-insured credit unions is down to 732, 21 percent less than June 1984. The total insurance losses related to mergers, liquidations and other problem cases is down to its lowest point since 1979.

In terms of numbers, mergers and liquidations are at their lowest level since 1982.

As of July 31, there have been 538 mergers, as compared to 642 in 1984 and 706 in 1983.

Also, there has been so far this year 50 mergers that required the NCUSIF assistance. This is compared to 92 assisted mergers in 1984 and 203 in 1983.

Turning to liquidations, the number of involuntary liquidations continues to decline for the fourth consecutive year. As of July 31, there were 26 cases, down from 38 in 1984 compared to the 1981 peak of 251.

Projecting through the rest of fiscal year 1985, we believe our insurance losses will be only approximately $22 million, the lowest level in 6 years. This reduced amount of loss can be attributed to the following reasons:

One, we have been able to increase our examiner force, primarily by reducing our Washington office-based staff. We are now in a better position to act upon problems instead of reacting to them.

We are committed to a significant increase in training and education as well as a substantial expansion of our examiner staff.

Two, instead of simply putting money into troubled credit unions, we have developed a list of experienced resource people capable of working in the credit union to turn it around. Typically, a resource sharer is a result-oriented credit union person with proven experience, who we pay directly out of the Fund.

Three, our supervision and time involvement directly to credit unions has continued to increase and improve.

Four, the overall economy of the country is in a relatively healthy condition and likewise credit unions. The midwestern farm belt and its associated agriculturally related loans continues as our worst problem.

Were it not for the farm problems, our projections for losses in fiscal year 1986 would be much lower. As it is, we are anticipating losses for 1986 in the $20 to $25 million range.

During the past year, in the wake of the Ohio and Maryland savings and loan crises, many private insurance companies have come under extreme pressure. Credit union insurers, by and large, have held up well in these difficult times.

The National Credit Union Administration continues to support the dual chartering system and the option of private insurance for State-chartered credit unions. This arrangement has served the credit union movement well, providing strength and innovation growing out of competition.

Nevertheless, it is true that there has been a significant movement toward the NCUSIF in recent months. Of the $18 billion insured by private insurers at the end of 1984, almost $7 billion has applied to NCUSIF insurance with substantial additional applications anticipated by year end.

This has stretched our capacity, but we have been able to adjust by using State examiners, retired annuitants, and others to supplement our efforts.

Mr. Chairman, we are not seeking any major changes in legislation affecting the share insurance fund at this time. Having recently achieved the most significant capitalization statute, we have been and are most concerned with the proper implementation of this legislation.

However, while we are not asking for change, we are most hopeful that the Congress will extend the presently existing conservatorship authority.

NCUA's conservatorship authority was granted, on a temporary 3-year basis, by the Garn-St Germain Act of 1982. It has proven to be a most effective administrative tool of the NCUA Board in better ensuring the safety and soundness of credit unions.

Mr. Chairman, we have delivered to your staff a few minor and technical amendments to the conservatorship authority. Our major concern, however, is the authority itself and its rapidly approaching expiration date.

Since the conservatorship authority was granted, it has been used in nine cases involving assets of over $284 million. As I mentioned yesterday, we estimate that conservatorship has saved the share insurance fund at least $20 million in the last 3 years.

This concludes my statement. I thank the subcommittee for the opportunity to present these comments. I would be pleased to respond to any questions.

[Mr. Riley's prepared statement, on behalf of the National Credit Union Administration, follows:]

STATEMENT OF D. MICHAEL RILEY, DIRECTOR, OFFICE OF PROGRAMS, NATIONAL CREDIT UNION ADMINISTRATION

Mr. Chairman and members of the Subcommittee, I appreciate the opportunity, on behalf of the National Credit Union Administration, to provide you with an update on the National Credit Union Share Insurance Fund.

During the past year, the Share Insurance Fund has experienced the most significant development since its establishment in 1971. On January 21 of this year, the NCUSIF received approximately $760 million from insured credit unions as a deposit in their Insurance Fund. This action, quadrupling the size of the Fund, was the direct result of Congress' passage last year of Title VIII of Public Law 98-369.

This new statute provides for strengthening of the NCUSIF through the placement of a deposit by each insured credit union in an amount equalling one percent of the credit union's insured shares. The legislation accomplishes the objective of a strong and viable Fund solely through the financial support of insured credit unions; that is, through their one percent deposit. The deposit of each credit union will be adjusted for growth annually in accordance with changes in the credit union's insured shares.

The legislation establishes a new "normal operating level," or level of Fund equity to total insured shares, of 1.3%. Anything in excess of that level must be distributed to insured credit unions at least annually. At this operating level, the NCUA Board projects that, in the absence of extraordinary expenses, the annual earnings on Fund assets will be sufficient to meet the expenses of the Fund, and also to allow a waiver or rebate of each credit union's annual insurance premium as well as the declaration of dividend on Fund equity. In practice, this year we waived the insurance premium and will pay an approximate 6% dividend on deposits.

Finally, we are very proud that, in a first for a Federal deposit insurance fund, the NCUSIF received an unqualified, or "clean," opinion on its 1984 financial statements from a Big Eight accounting firm -- Ernst & Whinney, the Fund's outside auditor.

A clean opinion means that in Ernst & Whinney's judgment, the NCUSIF's financial statements, taken as a whole, are presented fairly in accordance with generally accepted accounting principles. This includes the establishment of adequate reserves to cover all losses which the Fund might reasonably be expected to experience from the problem credit unions it currently insures. We also anticipate an unqualified opinion this year.

Overall, the financial resources available to assure the safety of insured credit union deposits includes the $1.2 billion assets of the NCUSIF, its $100 million borrowing authority from the Treasury, and the Central Liquidity Facility's $600 million borrowing authority from the Treasury. In addition, we have an arrangement with the Federal Reserve Banks to deliver emergency cash to any federally insured credit union within one day.

Credit Union Performance

As I outlined in greater detail at yesterday's hearing, statistics for the first half of 1985 indicate continued strong growth and performance for credit unions. Savings in Federal credit unions grew substantially, and strong gains were also made in loans, assets and new members during the first six months of 1985. Based on the call reports of 10,320 Federal credit unions, savings are growing at an annual rate of over 28% this year, loans 12%, assets 26%, and new members 13%. Equally important because of its impact on our insurance fund, reserves in Federal credit unions grew at a 20% rate.

Finally, the number of problem code Federal and federally-insured credit unions is down to 732, 21% less than June 1984. The total insurance losses related to mergers, liquidations and other problem cases is down to its lowest point since 1979. In terms of numbers, mergers and liquidations are at their lowest level since 1982.

Mergers

In fiscal year 1985, the total number of mergers continues to decline. As of July 31, 1985, with 10 months of the fiscal year completed, there have been 538 mergers as compared to 642 in 1984 and 706 in 1983. Most credit union mergers continue to be voluntary -- 91% in 1985 compared to 86% in 1984 and 74% over the last 4 years. These mergers were consummated without cost to the NCUSIF. A voluntary merger makes sense when a credit union has recently lost all or part of its field of membership or otherwise is no longer economically viable.

As of July 31, 1985, 50 mergers in fiscal 1985 required NCUSIF assistance. This is compared to 92 assisted mergers in 1984 and 203 in 1983. The average cost per assisted merger, again as of July 31, was $114,076 as compared to $109,000 in 1984 and $131,000 in 1983. Estimated losses for fiscal year 1985 due to mergers are approximately $12 million.

Liquidations

Turning to liquidations, the number of involuntary liquidations continues to decline for the fourth consecutive year in 1985. As of July 31, 1985, there were 26 cases, down from 38 in 1984 compared to the 1981 peak of 251.

The total estimated cost of involuntary liquidations in 1985 is $8 million compared to slightly more than $9 million in 1984.

Cash Assistance To Credit Unions

The NCUSIF can provide three types of cash assistance to credit unions; capital notes, loans or deposits, and asset purchases. Capital notes constitute the bulk of this assistance. Under this program, cash is advanced to a credit union in exchange for an interest-free, subordinated note. This cash infusion improves the credit union's liquidity. It also can be used to acquire income-producing assets to offset the impact on nonearning assets or accumulated losses. Capital notes contain specific repayment schedules that reflect the earnings improvement projected for that credit union. As of July 31, 1985, the Insurance Fund held $36.3 million of capital notes. This represents a $4 million increase from the previous year. Since the inception of the capital notes program, the NCUA Board has approved notes totaling $46.4 million, of which $43.6 million had been disbursed and $7.3 million repaid as of July 31, 1985.

The NCUSIF occasionally provides liquidity to a less-troubled credit union either by extending an interest-bearing loan or by placing a share deposit in it. On July 31, 1985, outstanding loans and share deposits totaled $191,000, down $6.2 million from the previous year. The NCUSIF can also purchase certain types of assets. Fidelity bond claims have been purchased whenever the event leading to the claim seriously drained the credit union's cash. For example, in April 1983 the NCUSIF purchased a Penn Square National Bank Receiver's Certificate issued to a corporate Federal credit union in order to facilitate an assisted merger. A $2.35 million net balance remained on that certificate on July 31, 1985.

Noncash Assistance to Credit Unions

Noncash assistance, known as a guaranty account, represents a recognition by the Insurance Fund that a credit union has a negative book net worth. In effect, the agency grants a credit union permission to continue operating while technically insolvent. This permission gives the credit union a protected environment, i.e., time to return to a positive net worth without being declared insolvent. Such a declaration would force a merger or liquidation. A guaranty account is not issued to a credit union unless there is a likelihood of regaining solvency within a reasonable time. The issuance and subsequent amortization, or reduction, of guaranty accounts are strictly noncash transactions.

Guaranty accounts do not change the numbers on a credit union's financial statements. However, the net worth section of its balance sheet is footnoted to indicate the amount of negative book net worth acknowledged by the Insurance Fund through the issuance of a guaranty account. Almost all guaranty accounts are amortized on a predetermined schedule negotiated between the Insurance Fund and the credit union. The amortization schedule reflects profit improvement goals the credit union's directors and management are committed to achieving.

As of September 30, 1984, 71 credit unions had been granted noncash assistance of $54.2 million. This type of assistance has been reduced to $45.6 million as of June 30, 1985, and the number of credit unions receiving assistance is down to 50.

Purchase & Assumption

A purchase and assumption (P&A) transaction has elements of both a liquidation and a merger. P&As usually begin as involuntary liquidation cases. In a P&A, however, the NCUSIF does not immediately pay off all the shareholders and liquidate all of the credit union's assets. Instead, the Fund attempts to merge some portion of it into another credit union in an effort to avoid a complete liquidation. The Fund then retains and liquidates those assets not acquired by the other credit union and assumes those liabilities not otherwise assumed or paid off. A number of months may elapse between the date the Fund takes control of the failed credit union and the date a portion of it is sold off. A field of membership may or may not be transferred in the merger portion of the transaction. When necessary, the Fund will provide some form of assistance to facilitate the merger.

P&As are complex transactions that generally take longer to complete than a liquidation or an assisted merger. They usually are entered into when an assisted merger cannot be negotiated and a liquidation would be more expensive. So far in fiscal year 1985, there were seven new P&A cases, compared to eight in 1984, nine in 1983 and 15 in 1982.

The Fund's loss as a percentage of insured shares was lower in P&A cases than in assisted mergers or liquidations in 1985. The estimated P&A losses for fiscal year 1985 are approximately $2.3 million.

Projections

Projecting through the rest of fiscal year 1985, we believe our insurance losses will be approximately $22 million, including liquidation expenses of $8 million; merger expenses of $12 million, and P&A expenses of $2 million. This amount of loss, which will be the least experienced since 1979, can be attributed to the following reasons:

a. Staffing and Training - We have been able to increase our examiner force. We are now in a better position to act upon problems instead of reacting to them. We are committed to a significant increase in training and education as well as a substantial expansion of our examiner staff.

b. Resource Sharing - Instead of simply putting money into troubled credit unions, we have developed a list of experienced resource people capable of working in the credit union to turn it around. Typically, a resource sharer is a result-oriented credit union person with proven experience.

c. Our supervision of credit unions has continued to increase and improve.

d. The overall economy of the country is in a relatively healthy condition and likewise credit unions. The Midwestern Farm Belt continues as our worst problem.

Were it not for the farm problems, our projections for losses in fiscal year 1986 would be much lower. As it is, we are anticipating losses for '86 in the 20 to 25 million dollar range.

Private Insurance

During the past year, in the wake of the Ohio and Maryland savings & loan crises, many private insurance companies have come under extreme pressure. Credit union insurers, by and large, have held up well in these difficult times. The National Credit Union Administration continues to support the dual chartering system and the option of private insurance for state-chartered credit unions. This arrangement has served the credit union movement well, providing stength and innovation growing out of competition.

Nevertheless, it is true that there has been a significant movement toward the NCUSIF in recent months. Of the $18 billion insured by private insurers at the end of 1984, almost $6 billion has applied for NCUSIF insurance with substantial additional applications anticipated by year end. This has stretched our capacity but we have been able to adjust by using state examiners, retired annuitants and others to supplement our efforts. Working together with the credit union corporate system, U.S. Central, and the CLF, the NCUSIF has developed a system of providing cash to any troubled federally insured credit union within hours so as to avert crisis. The Central Liquidity Facility, the central bank of credit unions, has made lines of credit available, on a fully secured basis, to private insurance companies in order to provide stability in the entire credit union system and to insure that conversions into the NCUSIF can be made in an orderly manner.

Legislation

Mr. Chairman, we are not seeking any major changes in legislation affecting the Share Insurance Fund at this time. Having recently achieved the most significant capitalization statute, we have been and are most concerned with the proper implementation of this legislation. However, while we are not asking for change, we are most hopeful that the Congress will extend the presently existing conservatorship authority.

NCUA's conservatorship authority was granted, on a temporary 3-year basis, by the Garn-St Germain Act of 1982. It has proven to be a most effective administrative tool of the NCUA Board in better ensuring the safety and soundness of credit unions. It has remedial aspects not found in other forms of agency action. When undertaking conservatorship action, the agency, in effect, freezes an institution, thereby preventing a dissipation of assets that could have a substantial adverse effect on that credit union's members, creditors, and the NCUSIF. This authority is particularly valuable where publicity about a credit union's soundness may trigger substantial share withdrawals and thus endanger the credit union's deposit base and the soundness of the institution in general.

Conservatorship has other benefits. In some cases, obtaining control of a credit union's operations and assets has precluded its officials, suspected of self-dealing and other questionable activities, from either further dissipating assets or tampering with or destroying records of their activities, thereby preserving evidence where criminal activitiy was suspected.

It is also beneficial where the true causes of a credit union's problems, and thus the appropriate remedy, are not easily ascertainable. If problems are not sufficient to warrant liquidation, it allows the NCUA Board the flexibility to work with credit union personnel to reopen the institution while at the same time preserving its integrity. This is accomplished by controlling the impact of outside influences which could otherwise seriously impair its viability. Liquidations may sometimes be inevitable but the value of the credit union may have been preserved, or losses reduced, for the benefit of all concerned, by the use of the conservatorhip.

The conservatorship option is also a valuable tool in the case of federally insured state-chartered credit unions where the NCUA Board's ability to act is somewhat restricted, even though there is a consensus with the state authority that immediate action is necessary. Normally, the NCUA Board must wait for a state agency to place a credit union into liquidation and several months may elapse due to state procedural requirements. At that point, the NCUA Board accepts appointment as liquidating agent. During this period of time, it is the Insurance Fund which is at risk, not the state authority, but the state authority is unable to expedite the matter.

Mr. Chairman, we have delivered to your staff a few minor and technical amendments to the conservatorship authority. Our major concern, however, is the authority itself and its rapidly approaching expiration date. Since the conservatorship authority was granted, it has been used in nine cases involving assets of over $284 million. As I mentioned yesterday, we estimate conservatively that conservatorship has saved the Share Insurance Fund $20 million in the last three years.

This concludes my statement. I thank the Subcommittee for the opportunity to present these comments. I'd be pleased to respond to any questions.

ASSISTED MERGERS: SIX-YEAR HISTORY

Fiscal Year	1980	1981	1982	1983	1984	1985 *
Number of Assisted Mergers	63	98	167	203	92	50
Shares In Acquired Credit Union (millions)	1/ 36.7	1/ 56.3	1/ 71.0	1/ 82.8	172.9	20.0

UNASSISTED MERGERS: SIX-YEAR HISTORY

Number of Unassisted Mergers	250	235	459	503	550	488

PURCHASE AND ASSUMPTIONS: SIX-YEAR HISTORY

Number of Purchase and Assumptions	-	2	15	9	8	7
Shares In Acquired Credit Union (millions)	-	3.8	26.4	4.0	17.3	29.9

INVOLUNTARY LIQUIDATIONS: SIX-YEAR HISTORY

Number of Involuntary Credit Union Liquidations Commenced	239	251	160	50	38	26
Shares Paid (thousands)	$59,957	$78,639	$39,892	$9,954	34,840	$11,673
Percentage of Shares Paid to Total Shares in NCUSIF-Insured Credit Unions	.110%	.136%	.058%	.013%	.038%	.012%
Average Payout Per Credit Union Liquidated (thousands)	$250.9	$313.3	$249.3	$199.1	$916.8	$448.9

* 10 months.

1/ Book value of loan guarantees - Share data unavailable.

ATTACHMENT A

TABLE 1 - NATIONAL CREDIT UNION SHARE INSURANCE FUND

BALANCE SHEET
July 31, 1985

ASSETS	JULY 1984	JUNE 1985	JULY 1985
Investments			
U.S. Government Securities	$307,125,528.88	$1,072,088,087.26	$1,104,351,815.33
Other Securities	10,120,749.73	0.00	0.00
Total Investments	317,246,278.61	1,072,088,087.26	1,104,351,815.33
Advances to Credit Unions			
Capital Notes	32,333,712.15	36,898,772.18	38,212,950.06 1/
Share Deposits	1,502,033.00	212,687.70	191,221.83
Total Advances	33,835,745.15	37,111,459.88	38,404,171.89
Other Receivables			
Bond and Legal Claims	1,640,345.02	1,387,688.46	1,387,688.46
FDIC Receiver's Cert. (PENSQ)	5,449,350.10	4,036,481.28	4,036,481.28
Loans to Credit Unions	4,802,052.69	0.00	0.00
Real Estate Loans	1,416,252.90	1,173,219.77	1,173,738.94
Recoveries from Liquidated CU	15,914,372.86	12,140,062.22	13,307,939.25
	29,222,373.57	18,737,451.73	19,375,829.13
Loss Allow. for Possible Losses	5,092,740.10	3,026,388.54	2,231,380.64
Total Net Other Receivables	24,129,633.47	15,711,063.19	17,144,448.49
Assets Acq. from CUs (Net)	1,082,250.00	1,309,250.00	1,226,250.00
Loans Acq. from Guarantees (Net)	267,388.80	0.00	0.00
Cash	9,934.84	9,891.54	14,838.81
Interest Receivable	1,461,462.33	37,031,314.20	37,437,392.31
Other Assets	0.00	338.47	338.47
TOTAL ASSETS	378,832,891.38	1,164,938,684.83	1,186,879,364.10
LIABILITIES			
Accounts Payable:			
Trade Accounts Payable	1,728.84	0.00	0.00
Liquidation Claims	13,447,490.52	11,283,273.31	12,968,535.49
Unclaimed Monies	44,575.12	44,380.31	44,380.31
Operating Fund	50,377.63	(22,417.52)	85,879.00
Total Payable	13,544,172.11	11,305,236.10	13,098,794.80
Accrued Liabilities	0.00	245,474.00	191,225.00
Deferred Income	26,043,103.23	0.00	0.00
Unapplied Receipts	35.00	0.00	0.00
Total Other Liabilities	26,043,138.23	245,474.00	191,225.00
Estimated Losses on Guarantees	18,329,654.24	3,810,933.14	2,944,777.34
Prov. for Potential CU Losses	38,240,472.69	32,210,100.29	38,351,676.46
TOTAL LIABILITIES	96,157,437.27	47,483,891.53	52,586,591.53 2/
EQUITY			
CU Contributed Capital	0.00	860,970,[illegible].66	873,150,958.96
Fund Balance, Prior Year	233,209,020.74	201,5[illegible],734.21	201,619,084.13
Net Income	48,466,483.37	54,962,063.43	59,522,731.51
Fund Balance, Current Year	281,675,504.11	1,117,454,793.30	1,134,292,772.58
TOTAL LIABILITIES & EQUITY	$378,832,891.38	$1,164,938,684.83	$1,186,879,364.10

Comparative Analysis of NCUSIF Ratios
for Period Ending July 31, 1985

Balance Sheet Ratios	July 1984	June 1985	July 1985
1. Equity/Total Assets	74.4%	95.9%	95.6%
2. Equity/Investments	88.8%	104.2%	102.7%
3. Investments/Total Assets	83.8%	92.1%	93.1%
4. Equity/Insured Shares	0.33%	1.32%	1.34%
5. Prov. for Loss/CU Capital	0.0%	3.7%	4.2%
6. Non. Earn Assets/Total Assets	16.2%	7.9%	6.9%

1/ Total amount NCUAB approved for capital notes as of 7/31/85 is $46,421,681 of which $43,576,930 has been disbursed leaving an undisbursed capital note balance of $2,844,751. Of the disbursed amount, $7,263,980 has been repaid.

2/ Does not include contingent liabilities of $8,947,267 for which a reserve for loss of $2,944,777 has been established.

ATTACHMENT B
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Dennis C. Winans
DENNIS C. WINANS, COMPTROLLER

TABLE 2 - STATEMENT OF REVENUE AND EXPENSE
FOR THE PERIOD ENDING July 31, 1985

REVENUE	CURRENT MONTH	CURRENT MONTH BUDGET	FY-TO-DATE 1985	FY-TO-DATE BUDGET 1985	FY-TO-DATE 1984
Insurance Premiums	$ 44.19	$ 0.00	$ 15,715,779.12	$15,640,000.00	$49,727,609.45
Investment Income	9,383,809.74	8,767,778.00	65,255,112.88	61,374,448.00	24,762,852.86
Other	57,788.22	54,167.00	479,305.48	541,670.00	730,650.67
Total Revenue	9,441,642.15	8,821,945.00	81,450,197.48	77,556,118.00	75,221,112.98
EXPENSE					
Personal Services	553,338.20	555,992.00	5,312,738.28	5,359,920.00	4,893,545.91
Employee Benefits	86,579.02	73,878.00	673,050.78	738,760.00	559,826.75
Employee Travel	132,802.15	103,414.00	1,038,339.39	1,034,140.00	895,819.89
Rent/Comm./Util.	90,404.44	91,457.00	681,801.64	914,570.00	868,351.48
Administrative Costs	28,559.38	51,834.00	388,464.97	516,340.00	327,940.38
Contracted Services	10,068.00	60,492.00	444,271.79	604,920.00	343,848.78
Subtotal - Oper. Exp.	899,749.17	938,665.00	8,699,726.83	9,386,850.00	7,889,333.17
Liquidation Expense	1,235.86	0.00	21,389.48	0.00	1,434,033.28
Loss Provision Expense	3,980,841.00 1/	1,000,000.00	13,222,584.38	10,000,000.00	17,333,056.86
Loss on Sale of Investments	0.00	0.00	0.00	0.00	2,336,249.32
Miscellaneous Expense	(821.96)	0.00	(16,214.63)	0.00	(18,042.72)
Subtotal - Fin. Exp.	3,981,254.90	1,000,000.00	13,227,759.14	10,000,000.00	21,085,296.44
Total Expense	4,881,004.07	1,938,665.00	21,927,485.97	19,386,850.00	28,734,629.61
Net Income	$4,560,638.08	$6,883,280.00	$59,522,711.51	$58,169,268.00	$46,486,483.37
Fund Balance, Prior Year			$285,540,280.93		$235,209,020.74
Equity Distribution			83,921,176.80 2/		0.00
As Restated			201,619,104.13		235,209,020.74
Net Income			59,522,711.51		46,486,483.37
Fund Balance, Current Year			$261,141,815.64		$281,695,504.11

Comparative Analysis of NCUSIF Ratios for Period Ending July 31, 1985

Income Statement Ratios	Last Month	This Month	Prior FYTD	Current FYTD
1. Investment Inc./Total Revenue	98.7%	99.4%	32.9%	80.1%
2. Operating Exp./Total Revenue	8.7%	9.5%	10.2%	10.7%
3. Financial Exp./Total Revenue	17.8%	42.2%	28.0%	16.2%
4. Total Exp./Total Revenue	26.5%	51.7%	38.2%	26.9%
5. Net Income/Total Revenue	73.5%	48.3%	61.8%	73.1%

1/ Includes increases to reserves for EWS 4 and 5 credit unions in all Regions except VI.

2/ Represents prior years' Fund equity subject to adjustment, rebated to credit unions in the form of dividends.

Dennis Winans
DENNIS C. WINANS, COMPTROLLER

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Balance Sheets National Credit Union Share Insurance Fund

	September 30	
	1984	1983
ASSETS		
Investments-Note E		
U.S. Government Securities	$308,965,764	$275,419,965
Other securities	-0-	1,182,911
	308,965,764	276,602,876
Advances to credit unions:		
Capital notes	33,211,507	28,225,744
Share deposits	1,817,261	3,581,222
Loans	1,384,352	31,080
	36,413,120	31,838,046
Assets acquired from credit unions, at estimated net realizable value:		
Liquidating credit union assets	16,327,630	4,539,195
Receivers certificate	2,354,781	2,724,675
Amount due from bond claims	148,000	993,048
Loans	1,188,505	941,462
	20,018,916	9,198,380
Cash	4,149	25,299
Accrued interest receivable	2,406,306	609,594
Other assets	311,209	618,158
	$368,118,464	$318,892,353
LIABILITIES		
Due to NCUA-Operated Fund-Note G	$ 199,151	$ 344,321
Amounts due to insured credit union shareholders	9,186,133	3,903,709
Deferred insurance premium income	15,640,432	13,247,606
Estimated losses from supervised credit unions-Note C	45,700,000	43,832,556
Estimated losses from asset and merger guarantees	10,800,000	22,158,799
Other liabilities	1,052,487	196,341
TOTAL LIABILITIES	82,578,203	83,683,332
FUND BALANCE	285,540,261	235,209,021
	$368,118,464	$318,892,353

See notes to financial statements.

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Statements of Operations and Fund Balance National Credit Union Share Insurance Fund

	Year ended September 30 1984	1983
REVENUE		
Insurance premiums:		
Regular	$ 60,184,640	$ 51,251,571
Special assessment	-0-	52,286,030
	60,184,640	103,537,601
Interest income	30,850,925	21,187,528
Other income	115,629	311,017
TOTAL REVENUE	91,151,194	125,036,146
EXPENSES		
Provision for insurance losses	28,066,219	55,060,356
Administrative expenses–Note H:		
Employee benefits and wages	7,096,076	6,859,207
Travel expense	1,306,236	1,086,231
Facilities expense	1,097,138	1,159,169
Contracted services	458,917	636,203
Miscellaneous	468,119	574,109
Total Administrative Expenses	10,425,486	10,314,919
Collection expenses	-0-	577,224
Loss on sale of investments	2,328,249	1,795,423
TOTAL EXPENSES	40,819,954	67,747,922
Excess of revenue over expenses	50,331,240	57,288,224
Fund balance at beginning of year	235,209,021	177,920,797
FUND BALANCE AT END OF YEAR	$285,540,261	$235,209,021

See notes to financial statements.

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Statements of Changes in Financial Position National Credit Union Share Insurance Fund

	Year ended September 30 1984	1983
SOURCES AND USES OF CASH AND INVESTMENTS		
Excess of revenue over expenses	$ 50,331,240	$ 57,288,224
Charges (credits) to net income not affecting cash and investments:		
Provision for insurance losses	28,068,219	55,060,356
Payments relating to losses from supervised credit unions and asset and merger guarantees	(37,559,574)	(15,153,823)
Deferred insurance premium income	2,392,826	1,896,860
Accrued interest receivable	(1,795,712)	283,098
INCREASE IN CASH AND INVESTMENTS FROM OPERATIONS	41,436,999	99,374,715
Increase in:		
Advances to credit unions	(4,575,074)	(15,008,541)
Assets acquired from credit unions	(10,820,536)	-0-
Amounts due to insured credit union shareholders	5,282,424	-0-
Other liabilities	856,146	-0-
Decrease in:		
Assets acquired from credit unions	-0-	8,655,220
Other assets	306,949	3,070,079
Due to NCUA-Operating Fund	(145,170)	(8,604,452)
Mortgage payable	-0-	(2,275,294)
Amounts due to insured credit union shareholders	-0-	(5,704,607)
Other liabilities		(951,904)
	(9,095,261)	(20,819,499)
INCREASE IN CASH AND INVESTMENTS	32,341,738	78,555,216
Cash and investments at beginning of year	276,628,175	198,072,959
CASH AND INVESTMENTS AT END OF YEAR	$308,969,913	$276,628,175
Detail of cash and investments at end of year:		
Cash	$ 4,149	$ 25,299
Investments	308,965,764	276,602,876
	$308,969,913	$276,628,175

See notes to financial statements.

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Notes to Financial Statements
National Credit Union Share Insurance Fund

Sepember 30, 1984

NOTE A - ORGANIZATION AND PURPOSE

The National Credit Union Share Insurance Fund (Fund) was created by Public Law 91-468 (Title II of the Federal Credit Union Act) which was amended in 1984 by Public Law 98-369 as discussed in Note D. The Fund was established as a revolving fund in the Treasury of the United States under the management of the National Credit Union Administration (NCUA) Board for the purpose of insuring member share deposits in all federal credit unions and in qualifying state credit unions that request insurance. The maximum amount of insurance is $100,000 per shareholder.

NCUA exercises direct supervisory authority over federal credit unions and coordinates any required supervisory involvement with the state chartering authority for state-chartered credit unions insured by the Fund. These credit unions are required to report certain financial and statistical information to NCUA on a semiannual basis. Federal credit unions are subject to annual examination by NCUA. State supervisory authorities provide NCUA with examination reports on state-chartered credit unions. Information derived through the supervisory and examination process provides the Fund with the ability to identify credit unions experiencing financial difficulties that may require assistance from the Fund.

Credit unions experiencing financial difficulties may be assisted by the Fund in continuing their operations if the difficulties are considered by the Fund to be temporary or correctable. This special assistance may be in the form of a waiver of statutory reserve requirements, a guarantee account, and/or cash assistance. If continuation of the credit union's operations with Fund assistance is determined to be infeasible, a merger partner may be sought. If the assistance or merger alternatives are not considered practical, the credit union is liquidated.

In the first form of special assistance, waivers of statutory reserve requirements, the credit union is permitted to cease making additions to its regular reserve and, in more severe cases, to commence charging operating losses against its regular reserve. When all reserves have been depleted by the credit union, the Fund may provide a guarantee account in the amount of the reserve deficit. In addition, the Fund may provide cash assistance in the form of share deposits and capital notes or may purchase assets from the credit union.

Mergers of financially troubled credit unions with stronger credit unions may also require Fund assistance. Merger assistance may be in the form of cash assistance, purchase of certain assets by the Fund, and/or guarantees of the values of certain assets (primarily loans).

When a credit union is no longer able to continue operating and the merger and assistance alternatives are not considered practical, the Fund will liquidate the credit union, dispose of its assets, and pay members' shares up to the maximum insured amount. The values of certain assets sold (primarily loans) are at times guaranteed to third-party purchasers by the Fund.

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NOTE B - SIGNIFICANT ACCOUNTING POLICIES

Investments: Title II of the Federal Credit Union Act limits the Fund's investments to United States Government securities or securities guaranteed as to both principal and interest by the United States Government. Investments are stated at cost adjusted for amortization of premium and accretion of discount.

Advances to Credit Unions: The Fund provides cash assistance in the form of capital notes, share deposits, and loans to certain credit unions to assist them in continuing operations. Prior to October 1, 1982, the allowance for estimated losses from supervised credit unions was limited to the amount of cash assistance outstanding. As discussed below, effective October 1, 1982, the Fund began providing for total estimated losses from supervised credit unions.

Assets Acquired from Credit Unions: The Fund acquires the assets of liquidating credit unions pending their ultimate disposition. In addition, to assist in the merger of credit unions, the Fund may purchase certain credit union assets. Such assets acquired are recorded at their estimated net realizable value.

Deferred Insurance Premium Income: The Fund assesses each insured credit union a regular annual premium of 1/12 of 1 percent of member share deposits (insured member share deposits in the case of corporate credit unions) outstanding as of December 31 of the preceding year. Regular annual premiums are recognized as income ratably during the calendar year in which they are assessed. Regular annual premiums assessed but not yet recognized as income are classified as deferred income.

Under certain conditions, the Fund has been permitted to assess an additional premium, which annually could not exceed the regular annual premium. These special assessments were recognized as income in the fiscal year in which they were assessed. A special assessment of 1/12 of 1 percent was charged in 1983. None was charged in 1984. As described in Note D the Fund will no longer be permitted to assess an additional premium.

Estimated Losses from Supervised Credit Unions: Effective October 1, 1982, the Fund began providing for estimated losses from credit unions identified through the supervisory and examination process as experiencing financial difficulty but not yet liquidated or merged. Credit unions experiencing financial difficulty are classified by the Fund as "weak" or "unsatisfactory." Loss estimates are determined by management based on a case-by-case evaluation.

Prior to 1982, the Fund considered it impracticable to accumulate the necessary information and did not attempt to estimate potential losses from supervised credit unions experiencing financial difficulties but not receiving cash assistance or to the extent that any estimated loss would exceed the amount of outstanding cash assistance. Generally accepted accounting principles require that the Fund estimate and provide for the losses relating to these items.

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Estimated Losses from Asset and Merger Guarantees: Estimated losses from asset (primarily loan) guarantees made to third-party purchasers or made to credit unions to facilitate mergers are determined by management based on a case-by-case evaluation. Guarantees outstanding at September 30, 1984 and 1983 were $24 million and $70 million, respectively for which estimated losses of $10,800,000 and $22,158,799, respectively, had been provided.

Provision for Insurance Losses: Provision for insurance losses includes amounts relating to estimated losses from supervised credit unions and to estimated losses on asset and merger guarantees.

Reclassification: Certain 1983 amounts have been reclassified for comparative purposes.

NOTE C - ESTIMATED LOSSES FROM SUPERVISED CREDIT UNIONS

As discussed in Note B, effective October 1, 1982, the Fund changed its method of accounting for estimated losses from supervised credit unions. This change to a method of providing for such losses in accordance with generally accepted accounting principles requires consistent application through restatement of the prior years' financial statements. However, since the Fund considered it impracticable to determine the effect on the 1982 and the prior years' financial statements, the cumulative effect of the change has been included in insured credit union losses for the year ended September 30, 1983.

NOTE D - FUND CAPITALIZATION

Subsequent to September 30, 1984, the NCUA Board adopted final rules implementing Title VIII of Public Law 98-369, which provides for the capitalization of the Fund through the deposit by each insured credit union of an amount equal to 1 percent of its insured shares. This deposit will be returned to the insured credit union in the event that its insurance coverage is terminated, insurance coverage is obtained from another source, or the operations of the Fund are transferred from the NCUA Board. The aggregate deposit will be carried on the balance sheet as a separate component of fund balance. In addition, the law changed the basis for assessing the regular annual premium to 1/12 of 1 percent of insured member share deposits outstanding as of December 31 of the preceding year. The Fund will no longer be permitted to assess an additional premium.

The law requires that upon receipt of the 1 percent deposit, the total fund balance must be maintained at a normal operating level to be determined by the NCUA Board. The NCUA Board has determined this level to be 1.3 percent of insured shares. It is anticipated that insured credit unions will remit their 1 percent deposit during January, 1985. Based on the present fund balance, the NCUA Board has resolved to waive the 1985 share insurance premium.

NOTE E - INVESTMENTS

Investments consisted of the following at September 30:

	1984	1983
U.S. Government Securities		
U.S. Treasury bills	$229,158,339	$245,343,493
U.S. Treasury notes	79,807,425	15,880,842
U.S. Treasury bonds	-0-	9,565,017
Other Government Securities	-0-	4,630,613
	308,965,764	275,419,965
Israel notes, 9.75% due 1994	-0-	1,182,911
Total Cost	$308,965,764	$276,602,876
Total Market Value	$308,975,000	$273,190,000

NOTE F - AVAILABLE CREDIT

The Fund is authorized under the Federal Credit Union Act to borrow from the Treasury of the United States upon authorization by the NCUA Board to a maximum of $100,000,000 outstanding at any one time. The Central Liquidity Facility of NCUA is authorized to make advances to the Fund under such terms and conditions as may be established by the NCUA Board. No amounts were borrowed from these sources during 1984 or 1983.

NOTE G - TRANSACTIONS WITH NCUA-OPERATING FUND

Substantial administrative services are provided to the Fund by the NCUA Operating Fund. NCUA charges the Fund for these services on a monthly basis based on an estimate of actual usage. The cost of services provided by the NCUA Operating Fund was $8,173,857 and $7,920,297 for 1984 and 1983, respectively.

NOTE H - RETIREMENT PLAN

Employees of the Fund participate in the Civil Service Retirement System which is a contributory defined contribition retirement plan. Contributions to the Plan are based on a percentage of employees' gross pay and were $432,000 and $425,000 for 1984 and 1983, respectively.

Balance Sheets
National Credit Union Share Insurance Fund

	September 30	
	1983	1982
Assets		
Investments — Note 3		
U.S. Government Securities	**$275,419,965**	$196,357,134
Other securities	**1,182,911**	1,298,865
	276,602,876	197,655,999
Accrued interest receivable	**589,584**	892,692
Advances to credit unions:		
Capital notes	**28,225,744**	11,150,828
Share deposits	**3,581,222**	5,647,597
	31,806,966	16,798,425
Assets acquired from credit unions, at estimated net realizable value		
Liquidating credit union assets held	**4,638,196**	11,318,384
Receivers certificate	**2,724,675**	—
Amount due from bond claims	**893,048**	5,671,284
Real estate loans	**941,482**	854,846
Other loans	**31,080**	40,166
	9,228,480	17,884,680
Loans acquired under guarantee agreements	**56,701**	3,006,227
Cash	**25,299**	416,960
Other assets	**582,467**	682,010
	$318,892,353	$237,336,993
Liabilities and Fund Balance		
Due to NCUA — Note G	**$ 344,321**	$ 8,948,773
Amounts due to insured credit union shareholders	**3,903,709**	9,608,316
Mortgage payable — Note E	**—**	2,275,294
Deferred insurance premium income	**13,247,808**	11,350,746
Estimated losses from supervised credit unions — Note C	**43,832,556**	10,484,822
Estimated losses on asset and merger guarantees	**22,156,799**	15,600,000
Other liabilities	**196,341**	1,148,245
TOTAL LIABILITIES	**83,683,332**	59,416,196
Fund balance	**235,209,021**	177,920,797
	$318,892,353	$237,336,993

See notes to financial statements

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Statements of Operations and Fund Balance National Credit Union Share Insurance Fund

	Year Ended September 30 1983	 1982 (Unaudited)
Revenue		
Insurance premiums:		
Regular	$ 51,251,563	$ 44,854,791
Special assessment	52,286,238	29,945,000
	103,537,801	74,799,791
Interest income	21,187,528	18,897,171
Other income	311,817	1,344,104
TOTAL REVENUE	125,036,146	95,041,066
Expenses		
Insured credit union losses	55,060,356	77,458,126
Administrative Expenses — Note H:		
Employee benefits and wages	6,888,207	7,278,758
Travel expense	1,096,231	1,075,084
Facilities expense	1,188,189	1,134,501
Contracted services	536,293	834,639
Miscellaneous	574,109	490,434
Total Administrative Expenses	10,314,918	10,813,396
Collection expenses	577,224	1,820,464
Loss on sale of investments	1,796,423	1,805,591
TOTAL EXPENSES	67,747,922	91,897,597
Excess of revenue over expenses	57,288,224	3,143,469
Fund balance at beginning of year	177,920,797	174,777,328
FUND BALANCE AT END OF YEAR	$235,209,021	$177,920,797

See notes to financial statements

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Note A — Organization and Purpose

The National Credit Union Share Insurance Fund (Fund) was created by Public Law 91-468 (Title II of the Federal Credit Union Act). The Fund was established as a revolving fund in the Treasury of the United States under the management of the National Credit Union Administration (NCUA) Board for the purpose of insuring member accounts in all federal credit unions and in qualifying state credit unions that request insurance. The maximum amount of insurance is $100,000 per member account.

The NCUA exercises supervisory authority over credit unions insured by the Fund. These credit unions are required to report certain financial and statistical information to the NCUA on a semiannual basis and are also subject to periodic examination by the NCUA. Information derived through the supervisory and examination process provides the Fund with the ability to identify credit unions experiencing financial difficulties that may require assistance from the Fund.

Credit unions experiencing financial difficulties may be assisted by the Fund in continuing their operations if the difficulties are considered by the Fund to be temporary or correctible. This may entail special assistance by the Fund in the form of waiver of statutory reserve requirements, reserve guaranties, and/or cash assistance. If continuation of the credit union's operations with Fund assistance is determined not to be feasible, a merger partner may be sought. If the assistance or merger alternatives are not considered practical, then the credit union is placed into liquidation.

In the first form of special assistance, waivers of statutory reserve requirements, the credit union is permitted to cease making additions to its regular reserve, and, in more severe cases, to commence charging operating losses against its regular reserve. When all reserves have been depleted by the credit union, the Fund may allow the credit union to establish a noncash reserve guaranty account, whereby the credit union records a receivable from the Fund in the amount of its reserve deficit with a corresponding addition to reserves. When cash assistance to a credit union is considered necessary to keep it operating, the Fund may advance cash in the form of share deposits and capital notes to or purchase assets from the credit union.

Mergers of financially troubled credit unions with stronger credit unions may also require Fund assistance. Merger assistance is given in the form of cash assistance, purchase of certain assets by the Fund, and/or guarantees of the collectibility of certain assets (primarily loan portfolios).

When a credit union is no longer able to continue operating and the value of its assets is less than its members' shares and liabilities, the Fund will liquidate the credit union, dispose of its assets, and pay members' shares up to the insured maximum amount. The values of certain assets sold (primarily loans) are at times guaranteed to third-party purchasers by the Fund.

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Note B — Significant Accounting Policies

Investments: Title II of the Federal Credit Union Act limits the Fund's investments to United Government securities or securities guaranteed as to both principal and interest by the United States Government. Investments are stated at cost adjusted for amortization of premium and accretion of discount.

Advances to Credit Unions: The Fund provides cash assistance in the form of share deposits and capital notes to certain credit unions to assist them in continuing operations. At September 30, 1982, the allowance for estimated losses from supervised credit unions was limited to the amount of cash assistance outstanding and was included in the balance sheet as a reduction of advances to credit unions. As discussed below, effective October 1, 1982, the Fund began providing for total estimated losses from supervised credit unions. For comparative purposes, the 1982 allowance amount has been included with estimated losses from supervised credit unions.

Assets acquired from credit unions: The Fund acquires the assets of liquidating credit unions pending their ultimate disposition. In addition, to assist in the merger of credit unions, the Fund may purchase certain credit union assets. Such assets acquired are recorded at their estimated net realizable value.

Loans Acquired under Guarantee Agreements: Loans acquired from third-party purchasers under guarantee agreements are carried at estimated net realizable value.

Estimated Losses from Supervised Credit Unions: Effective October 1, 1982, the Fund began providing for estimated losses on credit unions identified through the supervisory and examination process as experiencing financial difficulty but not yet liquidated or merged. Loss estimates are determined by management based on a case-by-case evaluation.

Prior to 1982, the Fund considered it impracticable to accumulate the necessary information and did not attempt to estimate potential losses from supervised credit unions experiencing financial difficulties but not receiving cash assistance or to the extent that any estimated loss would exceed the amount of outstanding cash assistance. Generally accepted accounting principles require that the Fund estimate and provide for the losses relating to these items.

Estimated Losses on Assets and Merger Guarantees: Estimated losses on assets (primarily loan) guarantees outstanding at September 30, 1983 made to third-party purchasers or made to credit unions to facilitate mergers were estimated by management based on a case-by-case evaluation. Estimated losses on similar guarantees outstanding at September 30, 1982 were estimated by management based on historical guarantee loss experience ratios. Guarantees outstanding at September 30, 1983 and 1982 were $70 million and $100 million, respectively.

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Deferred Insurance Premium Income: The Fund assesses each insured credit union a regular annual premium of 1/12 of one percent of member share accounts outstanding as of December 31 of the preceeding year. Regular annual premiums are recognized as income ratably during the calendar year in which they are assessed. Regular annual premiums assessed but not yet recognized as income are classified as deferred income.

Under certain conditions, the Fund is permitted to assess an additional premium which annually may not exceed the regular annual premium. These special assessments are recognized as income in the fiscal year in which they are assessed. Such special assessments were 1/12 and 1/18 of one percent in 1983 and 1982, respectively.

Reclassifications: Certain 1982 amounts have been reclassified for comparative purposes.

Note C - - Estimated Losses From Supervised Credit Unions

At September 30, 1983, the Fund insured approximately $78 billion of credit union member share accounts maintained at approximately 16,000 credit unions. At September 30, 1983, approximately 1,100 insured credit unions with approximately $4.7 billion of share accounts have been identified through the NCUA supervisory and examination process as experiencing financial difficulties. As discussed in Note B, effective October 1, 1982, the Fund changed its method of accounting for estimated losses from supervised credit unions. This change to a method of providing for such losses in accordance with generally accepted accounting principles requires consistent application through restatement of the prior years' financial statements. However, since the Fund considered it impracticable to determine the effect on the 1982 and the prior years' financial statements, the cumulative effect of the change has been included in insured credit union losses for the year ended September 30, 1983.

Note D — Investments

Investments consisted of the following at September 30:

	1983 Cost	1982 Cost
U.S. Government Securities		
U.S. Treasury bills	$245,343,493	$148,200,961
U.S. Treasury notes	15,880,842	34,804,177
U.S. Treasury bonds	9,565,017	13,351,996
Other Government Securities	4,630,613	—
	275,419,965	196,357,134
Israel notes, 9.75% due 1994	1,182,911	1,298,865
	$276,602,876	$197,655,999
	Market Value	Market Value
	$273,188,350	$192,067,790

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The Israel notes were acquired from a merged credit union and are guaranteed as to principal and interest by the U.S. Government. They have a sinking fund agreement through which a portion of the notes may be redeemed by the issuer each June 30.

Note E — Mortgage Payable

As a result of the merger of two credit unions, the Fund obtained title to land and a building in exchange for a $2,275,294 mortgage to the surviving credit union. The mortgage was paid in full during 1983. Related interest expense for the year ended September 30, 1983 was $123,801.

Note F — Available Credit

The Fund is authorized under the Federal Credit Union Act to borrow from the Treasury of the United States upon authorization by the NCUA Board to a maximum of $100,000,000 outstanding at any one time.

The Central Liquidity Facility of the NCUA is authorized to make advances to the Fund under such terms and conditions as may be established by the NCUA Board.

No amounts were borrowed from these sources during 1983 or 1982.

Note G — Transactions with NCUA

Substantial administrative services are provided to the Fund by the NCUA operating fund. NCUA charges the Fund for these services on a monthly basis based upon actual usage. The cost of services provided by the NCUA operating fund for the year ended September 30, 1983 was $8,439,629.

Note H — Retirement Plan

Employees of the Fund participate in the Civil Service Retirement System which is a contributory defined contribution retirement plan. Contributions to the plan are based on a percentage of employees' gross pay. Pension expense for the year ended September 30, 1983 was $425,000.

Balance Sheets

National Credit Union Share Insurance Fund

	September 30	
	1982	1981 (Unaudited)
ASSETS		
Investments - Note D		
U.S. Government Securities	$196,367,134	$160,551,546
Securities Purchased from Credit Unions	1,299,865	1,416,354
Total Investments	197,666,999	161,967,900
Accrued Interest Receivable	662,062	1,337,616
Estimated Liquidation Value of Credit Union Assets Held	11,318,364	19,313,250
Advances to Credit Unions		
Share Deposits	11,180,838	7,537,859
Capital Notes	5,647,597	—
Amounts Due from Bond Claims	8,621,284	9,818,048
Real Estate Loans	884,846	—
Other Loans	903,326	850,000
Merger Assistance	—	500,000
Total	26,877,880	18,705,907
Less: Allowance for Possible Losses	14,007,983	—
	12,869,897	18,705,907
Loans Acquired Under Guarantee Agreements	3,006,227	3,533,132
Cash	416,880	236,103
Other Assets	682,010	216,435
TOTAL ASSETS	$226,612,169	$205,310,343
LIABILITIES AND FUND BALANCES		
Due to NCUA - Note G	$ 8,048,773	$ 5,956,995
Amounts Due to Insured Credit Union Shareholders	8,808,318	13,580,727
Mortgage Payable - Note E	2,275,294	—
Deferred Insurance Premium Income	11,380,746	10,735,242
Estimated Losses on Asset and Merger Guarantees - Note C	16,800,000	—
Other Liabilities	1,140,243	260,051
TOTAL LIABILITIES	48,631,372	30,533,015
Fund Balance - Note C	177,980,797	174,777,328
TOTAL LIABILITIES AND FUND BALANCE	$226,612,169	$205,310,343

See Notes to Financial Statements

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Statements of Operations and Fund Balances

National Credit Union Share Insurance Fund

	Year Ended September 30	
	1982 (Unaudited)	1981 (Unaudited)
REVENUE		
Insurance Premiums		
Federal	$ 49,676,474*	$ 27,657,296
State	25,723,317*	14,077,239
Total Insurance Premium Income	74,796,791	41,734,535
Income From Investments		
U.S. Government Securities	18,267,534	19,032,776
Share Deposits in Credit Unions	432,834	771,538
Securities Purchased from Credit Unions	166,803	128,584
Total Income from Investments	18,867,171	19,932,898
Interest on Loans		
Loans Purchased from Credit Unions	985,606	488,634
Loans Made to Credit Unions	23,701	89,238
Total Income from Interest on Loans	1,009,307	577,872
Miscellaneous Income	334,797	176,959
TOTAL REVENUE	95,041,088	62,422,264
EXPENSES		
Operating		
Personal Services	6,603,210	5,630,110
Employee Benefits	675,846	540,106
Employee Travel	1,675,084	1,015,850
Rent, Communication, Utilities	1,134,601	950,496
Administrative Costs	864,227	611,754
Contracted Services	834,690	565,750
Other	(13,793)	—
Total Operating Expenses	10,813,306	9,313,835
Loss from Insured Credit Unions		
Merger of Credit Unions	17,372,021	12,001,925
Liquidation of Credit Unions	22,572,356	27,848,021
Provision for Losses on Advances to Credit Unions	14,097,883	—
Provision for Estimated Losses on Asset and Merger Guarantees	18,650,036	—
Losses on Assets Acquired	7,333,633	4,095,517
Collection	1,030,494	119,401
Other	82,385	—
Total Loss from Insured Credit Unions	79,278,815	43,864,864
Loss on Sale of Investments	1,095,891	—
TOTAL EXPENSES	91,887,997	53,178,780
EXCESS OF REVENUE OVER EXPENSE	3,149,469	9,243,564
Fund Balances at Beginning of Year	174,777,328	165,620,192
Prior Period Adjustments	—	(86,428)
Fund Balances at End of Year	$177,926,797	$174,777,328

* 1982 Insurance Premiums include revenue from the regular premium and the special premium assessment.

See Notes to Financial Statements

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NOTES TO FINANCIAL STATEMENTS

NATIONAL CREDIT UNION SHARE INSURANCE FUND

NOTE A — ORGANIZATION AND PURPOSE

The National Credit Union Share Insurance Fund (Fund) was created by Public Law 91-468 (Title II of the Federal Credit Union Act). The Fund was established as a revolving fund in the Treasury of the United States under the management of the National Credit Union Administration (NCUA) Board for the purpose of insuring member accounts in all federal credit unions and in qualifying state credit unions that request insurance. The maximum amount of insurance is currently $100,000 per member account.

The NCUA exercises supervisory authority over credit unions insured by the Fund. These credit unions are required to report certain financial and statistical information to the NCUA on a semiannual basis and are also subject to periodic examination by the NCUA. Information derived through the supervisory and examination process provides the Fund with the ability to identify credit unions experiencing financial difficulties that may require assistance from the Fund.

Credit unions experiencing financial difficulties may be assisted by the Fund in continuing their operations if the difficulties are considered by the Fund to be temporary or correctible. This may entail special assistance by the Fund in the form of waiver of statutory reserve requirements, reserve guaranties, and/or cash assistance. If continuation of the credit union's operations with Fund assistance is determined not to be feasible, a merger partner may be sought. If the assistance or merger alternatives are not considered practical, then the credit union is placed into liquidation.

In the first form of special assistance, namely waivers of statutory reserve requirements, the credit union is permitted to cease making additions to its regular reserve and, in more severe cases, to commence charging operating losses against its regular reserve. When all reserves have been depleted by the credit union, the Fund may allow the credit union to establish a noncash reserve guaranty account, whereby the credit union records a receivable from the Fund in the amount of its reserve deficit with a corresponding addition to reserves. When cash assistance to a credit union is considered necessary to keep it operating, the Fund may advance cash to or purchase assets from the credit union.

Mergers of financially troubled credit unions with stronger credit unions may require Fund assistance. Merger assistance is given in the form of cash assistance, purchase of certain assets by the Fund, and/or guarantees of the collectibility of certain assets (primarily loan portfolios).

When a credit union is no longer able to continue operating and the value of its assets is less than its members' shares and liabilities, the Fund will liquidate the credit union, dispose of its assets, and pay members' shares up to the insured maximum amount. The values of certain assets sold (primarily loans) are at times guaranteed to third-party purchasers by the Fund.

NOTE B — SIGNIFICANT ACCOUNTING POLICIES

Investments: Title II of the Federal Credit Union Act limits the Fund's investments to United States Government securities or securities guaranteed as to both principal and interest by the United States Government. Investments are stated at cost adjusted for amortization of premium and accretion of discount.

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Estimated Liquidation Value of Credit Union Assets Held: When a decision is made to liquidate a credit union, the Fund records the estimated amount recoverable from liquidation of the credit union's assets and a corresponding estimated loss on liquidation. In addition, to assist in the merger of certain credit unions, the Fund may purchase certain credit union assets. These are recorded at net realizable value.

Advances to Credit Unions: The Fund provides cash to certain credit unions to assist them in continuing operations. Such cash assistance is made in the form of share deposits, capital notes, or purchase of certain assets, including bond claims, real estate and other loans. Cash assistance may or may not be interest-bearing. An estimated allowance for losses against such advances was provided for the first time at September 30, 1982, based upon the Fund's evaluation of the recoverability of each advance.

Loans Acquired under Guarantee Agreements: Loans acquired from third-party purchasers under guarantee agreements are carried at estimated net realizable value which is computed based upon experience with similar asset guarantees.

Estimated Losses on Asset and Merger Guarantees: Losses on asset (primarily loan) guarantees made to third-party purchasers or made to credit unions to facilitate mergers are estimated using historical guarantee loss experience ratios based primarily on contracts executed prior to late 1981, applied to year-end outstanding guarantee balances which totaled $100 million at September 30, 1982. The Fund provided an estimate for such losses for the first time at September 30, 1982.

Deferred Insurance Premiums Income: The Fund assesses each insured credit union a regular annual premium of 1/12 of one percent of member share accounts as of December 31 of the preceding year. Premiums collected are taken into income ratably during the calendar year for which they were assessed. Premiums collected but not yet taken into income are classified as deferred income.

Under certain conditions, the Fund is permitted by statute to assess an additional premium to insured credit unions not to exceed the regular annual premium. These premiums are taken into income in the fiscal year in which they are assessed.

NOTE C — RISK OF LOSS FROM SUPERVISED CREDIT UNIONS

The Fund insures approximately $65 billion of credit union member share accounts maintained at approximately 17,000 credit unions. At September 30, 1982, approximately 1,200 insured credit unions with approximately $4.6 billion of share accounts have been identified through the NCUA supervisory and examination process (as discussed in Note A) as experiencing financial difficulties. Certain of these credit unions are being subjected only to increased supervision. Others are receiving special assistance from the Fund in the form of reserve requirement waivers, reserve guaranties, and cash assistance. Under the special assistance program, at September 30, 1982, the Fund has outstanding noncash reserve guaranties of approximately $48 million and Board authorization for additional cash advances through capital notes of approximately $20 million. Credit unions experiencing more severe financial problems, that are not considered to be able to continue operations, are in process of merger or liquidation.

As discussed in Note B, the Fund records assets acquired from credit unions in liquidation at estimated net realizable value, provides an estimated allowance for losses on advances to credit unions under the cash assistance program, and provides an estimate for losses on asset and merger guarantees. However, since the Fund considers it impracticable to accumulate the necessary information, the Fund does not attempt to estimate potential losses from (1) credit unions identified as experiencing financial difficulties but not receiving cash assistance, or (2) credit unions receiving cash assistance to the extent that any estimated loss would exceed the amount of outstanding cash assistance. Generally accepted accounting principles require that the Fund estimate and provide for the losses relating to these items.

NOTE D — INVESTMENTS

Investments consisted of the following at September 30, 1982:

	Cost	Market Value
U.S. Government securities		
U.S. Treasury bills	$148,200,961	$148,200,961
U.S. Treasury notes	34,804,177	32,440,455
U.S. Treasury bonds	13,351,996	10,365,574
	196,357,134	**191,006,990**
Israel notes, 9.75%, due 1994	1,298,865	1,060,800
	$197,655,999	**$192,067,790**

The Israel notes were acquired from a merged credit union and are guaranteed as to principal and interest by the U.S. Government. They have a sinking fund agreement through which a portion of the notes may be redeemed by the issuer each June 30.

NOTE E — MORTGAGE PAYABLE

As a result of the merger of two credit unions, the Fund obtained title to land and a building in exchange for a $2,275,294 mortgage to the surviving credit union. The mortgage is payable in full on January 10, 1985, with extension to January 10, 1987 at the option of the Fund. The mortgage bears interest at the prime rate subject to a minimum rate of 12% and a maximum rate of 17%.

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NOTE F — AVAILABLE CREDIT

The Fund is authorized under the Federal Credit Union Act to borrow from the Treasury of the United States upon authorization by the NCUA Board to a maximum of $100,000,000 outstanding at any one time.

The Central Liquidity Facility of the NCUA is authorized to make advances to the Fund under such terms and conditions as may be established by the NCUA Board.

No borrowings were outstanding from these sources at September 30, 1982.

NOTE G — TRANSACTIONS WITH NCUA

Substantial administrative services are provided to the Fund by the NCUA operating fund. NCUA charges the Fund for these services on a monthly basis based upon actual usage of services.

NOTE H — RETIREMENT PLAN

Employees of the Fund participate in the Civil Service Retirement System which is a contributory defined benefit retirement plan. Contributions to the Plan are based on a percentage of employees' gross pay.

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NATIONAL CREDIT UNION ADMINISTRATION
Share Insurance Fund Balance Sheets

	September 30	
	1981	**1980**
ASSETS		
Investments		
U.S. Government Securities	**$ 160,551,546**	$ 140,336,875
Share Deposits in Credit Unions (2)	**7,537,859**	9,132,265
Securities Purchased from Credit Unions (3)	**1,416,354**	2,293,306
Total Investments	**$ 169,505,759**	$ 151.762.446
Receivables		
Estimated Recoveries from Credit Unions in Liquidation (1)	**$ 18,380,500**	$ 16.218.890
Advances to Credit Unions for:		
Bond Claims in Process	**9,818,048**	2.750,000
Merger Assistance	**500,000**	500,000
Accrued Interest: (1)		
U.S. Government Securities	**1,305,668**	1.421.224
Securities Purchased from Credit Unions	**31,948**	44.155
Loans to Credit Unions	**0**	88.417
Cost to Administer Unclaimed Shares (4)	**85,663**	73.579
Other	**130,772**	238.958
Total Receivables	**$ 30,252,599**	$ 21.335.223
Loans		
Loans Purchased from Credit Unions, Net (1)	**$ 3,533,132**	$ 7.546.635
Loans Made to Credit Unions (5)	**850,000**	6.314.500
Total Loans	**$ 4,383,132**	$ 13.861.135
Cash	**$ 236,103**	$ 10.831
Prepaid Items	**0**	81.325
Land, Building and Equipment Purchased from Credit Unions (6)	**932,750**	1.142.750
Total Assets	**$ 205,310,343**	$ 188.193.710
LIABILITIES AND FUND BALANCES		
LIABILITIES		
Accounts Payable:		
Shareholders (8)	**$ 13,560,727**	$ 6,532.019
Operating Fund (7)	**5,956,995**	6.489.733
Trade	**101,485**	70.254
Unapplied Receipts	**136,783**	13.405
Accrued Travel Expenses	**41,783**	4.033
Total Accounts Payable	**$ 19,797,773**	$ 13.109.444
Deferred Insurance Premium Income (1)	**$ 10,735,242**	$ 9.464.074
Total Liabilities	**$ 30,533,015**	$ 22.573.518
Contingent Liabilities (1)(9)		
FUND BALANCES	**$ 174,777,328**	$ 165.620.192
Total Liabilities and Fund Balances	**$ 205,310,343**	$ 188.193.710

The Accompanying Notes to Financial Statements are an Integral Part of these Statements.

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NATIONAL CREDIT UNION ADMINISTRATION
Share Insurance Fund Statements of Operations and Fund Balances

	Year Ended September 30	
	1981	1980
INCOME		
Insurance Premiums		
Federal (Net)	$ 27,657,286	$ 25,681,831
State (Net)	14,077,239	12,812,543
Total Insurance Premium Income	$ 41,734,525	$ 38,494,374
Income From Investments		
U.S. Government Securities	$ 19,032,776	$ 13,318,711
Share Deposits in Credit Unions	771,538	400,395
Securities Purchased from Credit Unions	128,584	208,182
Total Income from Investments	$ 19,932,898	$ 13,927,288
Interest on Loans		
Loans Purchased from Credit Unions	$ 488,634	$ 672,640
Loans Made to Credit Unions	89,238	375,302
Total Income from Interest on Loans	$ 577,872	$ 1,047,942
Miscellaneous Income	$ 176,969	$ 61,950
Total Income	$ 62,422,264	$ 53,531,554
EXPENSES		
Operating		
Personal Services	$ 5,630,110	$ 5,021,361
Employee Benefits	540,106	522,870
Employee Travel	1,015,650	723,120
Rent, Communications and Utilities	950,466	870,416
Administrative Costs	611,754	573,111
Contracted Services	565,750	620,928
Total Operating Expenses	$ 9,313,836	$ 8,331,806
Financial Costs		
Loss Provision (1)	$ 4,095,517	$ 2,633,727
Collection	119,401	46,169
Merger	12,001,925	9,669,854
Other	0	50,029
Total Financial Costs	$ 16,216,843	$ 12,399,779
Liquidation (1)		
Federal	$ 23,996,526	$ 15,999,390
State	3,651,495	4,131,505
Total Liquidation Expenses	$ 27,648,021	$ 20,130,895
Total Expenses	$ 53,178,700	$ 40,862,480
NET INCOME	$ 9,243,564	$ 12,669,074
FUND BALANCES BEGINNING OCTOBER 1, 1980 AND 1979	$ 165,620,192	$ 152,610,126
Prior Period Adjustments (10)	(86,428)	340,992
Net Income	9,243,564	12,669,074
FUND BALANCES ENDING SEPTEMBER 30, 1981 AND 1980	$ 174,777,328	$ 165,620,192

The Accompanying Notes to Financial Statements are an Integral Part of these Statements.

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NOTES TO FINANCIAL STATEMENTS AS OF SEPTEMBER 30, 1981 AND 1980

National Credit Union Administration Share Insurance Fund

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation:

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles and the requirements of the Comptroller General of the United States.

External Audit:

The NCUSIF financial statements have been audited by the General Accounting Office. In the Comptroller General's opinion dated October 2, 1981 the statements were found to present fairly the financial position and results of operations of the NCUSIF as of December 31, 1980, the most recent audit. Copies of the audit are available upon written request to the Department of Insurance.

Internal Audit:

In addition to the review by the General Accounting Office, the NCUA Internal Auditor, periodically audits and reviews NCUSIF programs monitoring internal control and effectiveness. The most recent Internal Audit Report is dated March 20, 1981 and discusses desirable improvements in the loan management system and accounting for share payouts.

General:

These statements include accountability for assets and liabilities of closed insured credit unions for which the NCUA Board acts as liquidating agent.

Securities:

U.S. Government Securities and securities purchased from credit unions are carried at cost adjusted for amortization of premium and accretion of discount. Amortization and accretion are computed on a daily straight-line basis from the date of acquisition to the date of maturity.

Accrued Interest Receivable:

The entire amount represents interest due to the NCUSIF within one year.

Share Insurance Premiums:

Insurance premiums are due from insured credit unions on or before January 31, of each year, in advance, at an annual rate of 1/12 of one percent on the total amount of member share accounts in such credit unions at the close of the preceding calendar year. Premiums are then amortized to income on a monthly basis during the calendar year.

Allowance for Loan Losses:

The provision for losses on loans purchased from liquidating credit unions is based on a fair market value formula applied to each loan portfolio purchased. However in the case of purchases of loan portfolios under repurchase guarantees a 95 percent loss ratio is applied to the portfolio balances when the loans are acquired. An evaluation of total loans purchased is performed periodically by management as a basis for maintaining an adequate allowance account. An adjustment, based upon payment experience within the most recent 90-day period, is also made annually to further provide for an adequate allowance position. The allowance account as of September 30, 1981 amounts to $10.2 million dollars which is 74 percent of loan balances totaling $ 13.8 million.

Estimated Recoveries from Credit Unions in Liquidation:

It is the policy of the NCUA Board to establish an estimated recovery and to expense an estimated loss at the time an insured credit union fails and is involuntarily liquidated. For example, when a credit union enters liquidation, an estimate is made of its net worth. A ratio of 70 would indicate that the NCUSIF should recover 70 cents on each dollar paid out to shareholders. The remaining 30 cents is considered a loss to the fund and is immediately charged to Liquidation Expense in the Statement of Operations. The recoveries and expenses are adjusted to actual as required based on financial developments during the liquidation process.

The NCUSIF does not state its estimated contingent liability for unknown future insured credit union closings because such estimates are impossible to make. The NCUSIF's contingent liability for eventual net losses depends upon factors which cannot be assessed until or after an insured credit union has actually failed. The entire NCUSIF and its borrowing authority are available, however, for such contingencies.

2. NCUSIF SHARE ACCOUNTS IN CREDIT UNIONS

Share deposits are made in financially troubled credit unions under special assistance authority granted in Section 208 of the Act. As of September 30, 1981, the outstanding balance of $ 7.5 million in this account represented deposits in five Federally-insured credit unions. The comparable figure for September 30, 1980 was $ 9,132,264.

3. SECURITIES PURCHASED FROM CREDIT UNIONS

Securities purchased from credit unions are Israel Notes maturing June 30, 1994 with a coupon rate of 9.75 percent. The effective yield on these notes is 8.5 percent. The notes were acquired by the NCUSIF in 1978 from a merged Federal credit union. The notes have a sinking fund agreement in which a portion or total par value of the notes may be called by the paying agent each June 30th. As of September 30, 1981, a total of $ 100,000 had been redeemed through this agreement. The book value of the notes exceed the market value by approximately $ 480,000 as of September 30, 1981.

4. COSTS TO ADMINISTER UNCLAIMED SHARES

Administrative costs to maintain records of unclaimed shares are initially absorbed by the NCUSIF and accumulate in this account. Reimbursement for administrative costs is made at the time the unclaimed shares are transferred to the appropriate state or territory.

5. LOANS MADE TO CREDIT UNIONS

The NCUSIF currently has one (1) loan outstanding to the Houston Milk Producers Federal Credit Union.

6. LAND, BUILDING AND EQUIPMENT PURCHASED FROM CREDIT UNIONS

These assets were purchased from Parris Island Federal Credit Union which merged with Navy Federal Credit Union in 1980. The land and building are currently values at $885,000 and the equipment is values at $ 47,750.

7. ACCOUNTS PAYABLE – OPERATING FUND

This account is used for interfund transactions between the NCUSIF and the Operating Fund of NCUA. During each fiscal year, a portion of operational and administrative expenses related to NCUSIF activities are paid by the Operating Fund. Monthly transfers of cash are then made to the operating fund from the NCUSIF. At December 31, 1981, the payable had been reduced to $847,000.

8. ACCOUNTS PAYABLE – SHAREHOLDERS

The liability that remains for claims owed to members after initial attempts to make payments have been unsuccessful.

9. CONTINGENT LIABILITIES

Loan guarantee contracts and reserve guaranty agreements (non-cash assistance) represent contingent liabilities to the NCUSIF. The NCUSIF has $ 117.7 million outstanding in liquidated or merged credit union loan portfolio guarantees and $ 54 million in reserve guaranty agreements. The comparable figures for September 30, 1980 are $ 60.1 million in guarantee account and $ 40.3 million in guaranty agreements.

10. PRIOR PERIOD ADJUSTMENTS

These figures were made to close out the OEO guaranty program of 1971 which provided selected limited income to Federal credit unions with funds to store up reserves and qualify for share insurance.

Table 3.—Income, Expenses, and Net Income of the National Credit Union Share Insurance Fund, Fiscal Years 1980 and 1979
(Amounts in thousands)

Item	1980[1]	1979[1]
Income:		
Insurance Premiums	$38,495	$35,178
Interest Income from:		
Investments	13,319	9,178
Loans Acquired	673	441
Investments Acquired	208	201
Loans to Credit Unions	375	361
Other Interest Income	400	494
Total Interest Income	14,975	10,675
Miscellaneous Income	62	83
Total Income	53,532	45,936
Expenses:		
Personal Services	5,021	3,983
Employee Benefits	523	407
Employee Travel	723	494
Rent, Comm., Utilities	871	368
Administrative Cost	573	238
Contracted Services	621	383
Financial Cost	12,400	1,665
Liquidation Expenses	20,131	4,709
Total Expenses	40,863	12,247
Net Income	12,669	33,689

[1] Fiscal years ended September 30.

Table 4.—Income and Expenses of the National Credit Union Share Insurance Fund, Fiscal Years 1971 to 1980
(Amounts in thousands)

Fiscal Year[1]	Total Income			Expenses and Losses			Net income Added to Share Insurance Fund
	Total	Share Insurance Assessments[2]	Investments and Other Sources	Total	Share Insurance Losses & Expenses	Administrative & Operating Expenses	
Total 1971-80	$248,112	$196,838	$51,274	$87,551	$34,387	$53,163	$160,561
1971	3,268	3,168	100	515	—	515	2,753
1972	8,534	8,037	497	597	1	596	7,937
1973	11,812	10,723	1,089	2,222	864	1,358	9,590
1974	15,148	12,871	2,277	3,460	1,589	1,871	11,688
1975	19,293	15,678	3,615	4,065	290	3,775	15,228
1976	22,799	18,432	4,367	6,757	1,222	5,535	16,042
1977	30,394	24,625	5,769	8,480	3,024	5,455	21,914
1978	37,396	29,631	7,765	8,345	2,557	5,788	29,051
1979	45,936	35,178	10,758	12,247	4,709	7,538	33,689
1980	53,532	38,495	15,037	40,863	20,131	20,732	12,669

[1] Fiscal year ended June 30 for 1971 to 1976 and as of September 30 for 1977 through 1980.

[2] Assessments are charged at a rate of one-twelfth of one percent of total shares as of December 31, and are net of rebates paid to liquidating credit unions.

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Table 2. – Total Assets, Liabilities and Equity of the National Credit Union Share Insurance Fund, Fiscal Years 1980 and 1979
(Amounts in thousands)

Item	1980[1]	1979[1]
Assets:		
Cash	$ 11	$ 917
Due from/to/operating-insurance fund	(6,490)	(975)
Due from trust fund	74	75
Accounts receivable	38,949	8,623
Interest receivable	1,554	1,685
Prepaid charges	81	151
Investments at cost	149,469	138,213
Investments acquired from credit unions	2,293	2,906
Loans acquired from credit unions (net)	7,547	6,194
Estimated recoveries from liquidations	16,219	8,706
Other assets (loans to credit unions)	7,457	5,561
Total Assets	217,164	172,057
Liabilities:		
Accounts Payable:		
Trade accounts payable	70	34
Shareholder payables	41,654	9,729
Unclaimed monies	338	147
Total	42,062	9,910
Accrued liabilities	4	–
Deferred income - (premiums)	9,464	9,189
Guaranty agreements (OEO)	–	344
Clearing accounts	14	4
Total Liabilities[2]	51,544	19,447
Equity:		
Fund Balances:		
Balance, beginning	152,951	118,921
Excess income over expenses	12,669	33,689
Adjustments to YTD earnings	–	–
Net income	12,669	33,689
Balance, ending	165,620	152,610
Total liabilities and equity	217,164	172,057

[1] Fiscal years ended September 30.

[2] Excludes contingent liabilities.

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The Insurance Fund now tries whenever possible to sell assets without any guarantee.

Merger and Asset Guarantees

Until 1981 the Insurance Fund routinely guaranteed the full value of loans and other assets of liquidated credit unions sold to third parties. These guarantees would also be granted when assets were acquired by another credit union in an assisted merger or purchase and assumption transaction. Consequently, the acquirers of these assets would have little incentive to aggressively collect or otherwise liquidate the guaranteed assets.

The Insurance Fund now tries whenever possible to sell assets without any guarantee. With certain assets, though, the Fund will guarantee a specified recovery value where there is a high degree of uncertainty as to what can be recovered. These are situations where external events (such as strikes) temporarily depress values. Here guarantees have increased the liquidation value of problem assets. Under no circumstances is an entire loan portfolio guaranteed. The table below sets out the cumulative history of the loan guarantee program.

Asset Guarantee Contracts - Cumulative History

(dollars in thousands)

	1971-1984
Number of Guarantee Contracts Written	1,675
Book Value of Loans and Other Assets Guaranteed	$535,817
Amount of Guarantees Issued	$298,445
Disbursements under Guarantee Contracts	$51,518
Guarantee Contracts Outstanding (Contingent Liability) on 9/30/84	$23,930
Guarantees Issued as Percentage of Book Value of Assets Guaranteed	55.7%
Loss Ratio on Matured Contracts (Disbursements as a Percent of Guarantees)	17.3%

During 1984 the Insurance Fund wrote just 68 loan and asset guarantee contracts, down from 222 in 1983. The amount of these new guarantees - $9,470,000 - was just 16% of the book value of the assets guaranteed. Through 1981, when the partial guarantee program was initiated, guarantees were equal to 79% of the book value of the assets guaranteed. The cumulative disbursements on matured contracts increased to 17.3% on September 30, 1984 from 11.5% as of the previous year-end. Two factors accounted for this increase. One, numerous contracts matured or were bought out in 1984. This clean up process required $17.1 million in cash outlays. However, the Insurance Fund's contingent liabilities under these guarantees decreased $45.9 million during 1984, to $23.9 million. Further, the Fund was able to reduce its reserve for future losses under these guarantees by $11.4 million during 1984. Two, in limiting its new guarantees to only the riskiest assets, the Fund automatically increased the probable loss percentage it could expect to absorb under each guarantee.

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TABLE 16 - CHANGES IN GUARANTEE CONTRACTS OUTSTANDING
MONTH ENDING
July 31, 1985

	Region I $ Amount	Region II $ Amount	Region III $ Amount	Region IV $ Amount	Region V $ Amount	Region VI $ Amount	Total
Balance 6/30/85	-0-	15/$558,484	1/$100,000	7/$2,613,709	25/$3,627,330	-0-	48/$6,900,523
Increases New Contracts	-0-	-0-	-0-	1/225,896	-0-	-0-	1/225,000
Decreases							
Repurchase Payments	-0-	83,140	-0-	95,238	11,371	-0-	189,910
Negotiated Settlements	-0-	69,000	-0-	10,000	107,480	-0-	186,480
Other Payments	-0-	-0-	-0-	-0-	30,692	-0-	30,692
Collections	-0-	27,956	-0-	-0-	4,727	-0-	32,683
Remaining Guar. Closed	-0-	13,750	-0-	118,967	386,706	-0-	318,431
Other	-0-	-0-	-0-	(805,000)	-0-	-0-	(800,000)
Percent of Final Settlement Paid to Prior Month's Remaining Contract Liability	-0-	82.4%	-0-	7.3%	10.5%	-0-	24.5%
Balance 7/31/85	-0-	10/$365,021	1/$100,000	7/$2,414,312	19/$3,087,184	-0-	37/$6,947,287

FISCAL YEAR-TO-DATE
July 31, 1985

	Region I $ Amount	Region II $ Amount	Region III $ Amount	Region IV $ Amount	Region V $ Amount	Region VI $ Amount	Total
Balance 9/30/84	63/$3,851,408	49/$3,306,143	23/$634,455	49/$6,294,969	67/$8,306,245	9/$316,275	260/$23,020,390
Increases: New Contracts	3/264,125	5/697,366	-0-	4/1,161,960	2/283,972	-0-	14/2,387,353
Decreases							
Repurchase Payments	32,734	388,358	56,778	812,174	378,088	3,000	1,671,160
Negotiated Settlements	1,693,455	861,848	254,171	1,358,416	2,504,284	190,824	7,056,778
Other Payments	13,601	-0-	-0-	1,457,307	190,114	-0-	1,672,112
Collections	389,241	429,488	162,060	974,031	1,896,918	-0-	3,770,744
Remaining Guar. Closed	1,232,494	1,918,386	61,461	2,138,349	1,483,631	120,051	6,084,942
Other	-0-	[illegible]	-0-	(890,888)	(955,006)	-0-	(885,868)
Percent of Final Settlement Paid to Prior Month's Remaining Contract Liability	61.1%	44.5%	58.6%	40.8%	40.8%	61.7%	49.6%
Balance 7/31/85	-0-	10/$365,021	1/$100,000	7/$2,414,312	19/$3,087,184	-0-	37/$6,947,287

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Chairman St Germain. Mr. Wolf?

STATEMENT OF FREDERICK D. WOLF, DIRECTOR, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION, GENERAL ACCOUNTING OFFICE

Mr. Wolf. Thank you, Mr. Chairman.

I am pleased to be here today to discuss our most recent financial audits of the Federal depository institution regulators, FDIC and FSLIC. Recently, much public concern has been expressed regarding the stability of the Nation's financial institutions.

In our 1984 audits, we gave qualified opinions to both FDIC and FSLIC indicating our concern about the recorded values of certain assets acquired during default prevention or liquidation activities. Let me first talk about our audit of FDIC.

In GAO's opinion, FDIC's 1984 financial statements significantly overstate the value of assets acquired from Continental Bank due to the lack of an allowance for loss on the $2.1 billion of poor quality loans and other assets acquired from Continental Bank as part of an assistance program. We believe FDIC should have recognized the probable loss on those assets in its accounts as of December 31, 1984.

The problems of Continental Bank are well-known to this subcommittee. Your September 1984 and July 1985 reports detail these problems which ultimately led to a run on the bank, and to the permanent assistance program announced in July 1984, which included the removal of $4.5 billion in problem loans from the bank.

In accounting for the permanent assistance program in 1984, FDIC did not establish an allowance for loss on the troubled loans acquired from Continental Bank, although FDIC's financial statements did state that ultimate collection of the loans was subject to significant uncertainties.

GAO believes that FDIC will experience substantial losses from the loan portfolio acquired from Continental Bank. Virtually all of the loans were classified, and many of the acquired loans had previously been written off by Continental Bank as partially or totally worthless. Further, a substantial majority of the loans transferred to FDIC are in troubled segments of the economy, such as oil and gas 52 percent, and commercial real estate 10 percent.

GAO believes that FDIC could have determined a reasonable range of probably losses associated with the troubled loan portfolio.

Chairman St Germain. When we had the hearing on Continental, the FDIC testified that they were indeed taking over those loans, which, as you have just stated, were basically uncollectible and had already been written off by the bank itself.

The bank usually tries not to write off a loan until the last resort; correct?

Mr. Wolf. Yes.

Chairman St Germain. Wouldn't it have been possible for the FDIC to come up with some instrument to measure what their losses may have been on the loans that they took over?

Mr. Wolf. We believe it was not only possible, but they should have done it and reported it in their financial statements.

Chairman St Germain. You may proceed.

Mr. WOLF. In May 1985, before FDIC published its financial statements, a range of estimated loss was determined by Continental Bank of between $551 million to $774 million. If FDIC had reported even the lower amount of the bank's range of estimated loss, its income would have been reduced by 30 percent.

FDIC's 1984 annual report did not include our opinion on its financial statements, a fact that surprised us. We had worked closely with FDIC's staff to have our opinion ready for publishing in their annual report. We believe FDIC should have included our opinion to fulfill its disclosure responsibility to the Congress and other users of its annual report and financial statements.

Let me now turn to FSLIC. In GAO's opinion, FSLIC's 1984 financial statements are fairly presented, but we are uncertain as to the ultimate net realizable value of claims against assets acquired from three large institutions that were closed in 1984.

As of December 31, 1984, FSLIC held $1.3 billion in claims against the assets of the three institutions.

Mr. MCKINNEY. Do you have the name of those three?

Mr. WOLF. Empire, Knox Federal, and San Marino Savings & Loan.

Mr. MCKINNEY. Good. Thank you.

Mr. WOLF. FSLIC had established a $468 million allowance for loss which was based on preliminary estimates that we believe probably did not include all possible costs. Further, the recency of the San Marino and Knox Federal failures along with inadequate loan records and pending and possible litigation affecting the three institutions, precluded determining a better estimate of the ultimate collectibility of the claims. Given these uncertainties, we were not able to satisfy ourselves that FSLIC's allowance for loss estimate was reasonable.

To understand the problems encountered in evaluating the net realizable value of the assets and to give a favor of the condition of some failed institutions, let me briefly discuss some of the conditions that existed at these institutions prior to their failures.

Overall, those institutions were characterized by rapid growth, primarily resulting from the use of brokered jumbo deposits used to fund highly speculative loans and real estate investments, and material deficiencies regarding management practices, lending policies, recordkeeping and compliance with Bank Board regulations.

For example, Empire's assets increased from $20 million to $320 million in 2 years. The rapid growth was based on a lending policy that created excessive amounts of large loans to purchase undeveloped land based on artificially inflated land prices, and to a large extent, in oil and gas activities.

San Marino's total assets increased from $2 million to $840 million at its failure in late 1984. Such growth was fostered primarily by the acceptance of brokered deposits to fund aggressive real estate lending activities. Also, San Marino often had an investment rather than a secured position in these projects, which complicated enormously the net realizable value determination.

I would like to close my testimony with a few observations on some of the broader issues which were raised as a result of our audits.

In today's world, prudently managing a bank or thrift institution is no longer an easy job. Beginning with the REIT problems in the mid-1970's, financial institutions entered a decade of turmoil and competition, while promising areas of growth have presented significant new risks. At the same time, the economy has shifted from growth and inflation, to significant business cycles, and for the past few years, relatively stable prices.

During that time, large banks poured money into foreign loans and the energy sector, and today, they are counting their current experience with many of these loans as nonperforming assets, and smaller banks have been troubled by agricultural loans.

But more so than the banks, the thrift industry has encountered the most severe financial difficulties. Until the mid-1970s, thrifts operated in a relatively stable environment until short-term interest rates skyrocketed.

Now a new problem has emerged: poor quality loans and investments. In order to earn a higher rate of return, some thrifts made questionable loans and direct investments which, they thought, offered greater profits, but also presented new and far greater risks.

While the thrift industry has appeared to become more profitable due to the general decline in interest rates, it remains to be seen if interest rates will remain stable long enough to allow the thrift industry to absorb losses related to poor quality loans and investments and rebuild its weakened net worth position. The concern we have over asset quality remains, and in fact is heightened, as many of these problems are slow to be identified.

Recent work we have performed at the request of Chairman Dingell's House Subcommittee on Oversight and Investigations revealed that Beverly Hills Savings & Loan assets grew from $402 million in 1979 to nearly $2 billion by the end of 1983, largely attributable to their involvement, often as an investor rather than a lender, in apartment projects, major office buildings, and hotel construction. The cost of this failure to FSLIC is not yet counted, but it will be high and it won't be the last one.

The Bank Board has recently observed that "the exercise of these nontraditional investment powers can expose institutions and the FSLIC to a degree of risk inconsistent with the purposes of" the laws establishing Federal insurance.

We certainly agree and would suggest that the subcommittee, in the course of these hearings on deposit insurance, reevaluate the insurance program; why it was set up and the type of financial institutions and product offerings it was intended to cover; and determine if certain activities of insured institutions should no longer qualify, or if some adjustment should be made to the insurance premiums these firms pay.

Finally, there is a need for full disclosure of nonperforming and uncollectible assets. We have concern that banks and thrifts have been far too slow to recognize the uncollectible portion of their assets. Failures of financial institutions have all too often appeared to leap upon us from nowhere. In retrospect, the failed institutions have been remiss—to be kind—in not establishing a reasonable reserve which recognizes the inherent potential loss in their loan portfolio and investment position.

This is why the role of the independent auditor becomes critically important. The auditor accepts a great deal of responsibility in auditing a bank or thrift, and some recent failures have called the auditors' performance into question. I am not sure I have the answer on that today, but it may involve a number of things: A closer study of internal controls in the loan function, a more conservative assessment of losses, a closer questioning of reserves, greater sharing of information with regulators, more disclosure about the entity's activities and risk management strategies and, finally, a more hard-nosed approach to the audits. Whatever the answer, auditors of financial institutions must recognize that they are auditing institutions of public trust, and conduct their audits in the most professional and responsible manner possible.

Mr. Chairman, this concludes my statement. I would be happy to address any questions the subcommittee may have.

[The prepared statement of Mr. Wolf and other pertinent material follow:]

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
EXPECTED AT 10 A.M.
SEPTEMBER 12, 1985

STATEMENT OF

FREDERICK D. WOLF, DIRECTOR

ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE

OF THE

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

ON GAO'S

1984 FINANCIAL AUDITS OF THE FEDERAL DEPOSIT INSURANCE CORPORATION AND FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our most recent financial audits of the federal depository institution regulators. Recently, much public concern has been expressed regarding the stability of the nation's financial institutions. The number of federally insured banks and savings and loans which was closed in 1984 was a post depression high, and the failure rate in 1985 has exceeded that pace. Perhaps more importantly, the number of so called problem institutions grows each time it is reported.

This morning, I will discuss the results of GAO's 1984 financial statement audits of the Federal Deposit Insurance Corporation (FDIC) and Federal Savings and Loan Insurance Corporation (FSLIC). The Board of the National Credit Union Administration (NCUA) manages a Share Insurance Fund which is audited by a public accounting firm. GAO audits the Fund by reviewing the firm's financial statement audit. I will briefly discuss our work at NCUA later in my testimony.

GAO's financial audits did not assess the adequacy of the deposit insurance funds and, therefore, I will not address that topic in my testimony. I will, however, discuss how assistance provided to troubled or failed institutions affects the financial statements, and the audit issues that arise from such assistance. I will also mention one of GAO's major projects to improve financial management in the federal government, and, finally, I will leave you with my observations on some of the broader issues raised by my testimony on the deposit insurance funds.

Before discussing our most recent audits of FDIC and FSLIC, I would like to talk briefly about the accounting and auditing profession in this country and GAO's responsibilities for conducting financial statement audits of the deposit insurance funds.

THE ROLE OF ACCOUNTING AND AUDITING

The United States has a vigorous system of public security markets, capital markets and private enterprise which is one of the backbones of our economy and is second to none in the world. These capital markets are based, to a very large degree, on the concept of full and fair disclosure as the best mechanism for investor protection.

Full and fair disclosure has three primary components:

--a set of generally accepted accounting and disclosure principles which, if properly applied, should result in a full and fair view of an organization's financial position and the results of its operations,

--a responsibility by management to prepare financial statements that provide for full and fair disclosure, and

--annual independent audits that ensure the financial statements and disclosures by management do, in fact, provide a fair picture of the organization.

A comprehensive set of accounting and disclosure standards is necessary to ensure that entities follow the same rules and concepts in preparing financial reports and disclosures. Standards need to be consistently applied so that similar transactions or events will be reported the same way over time and among similar organizations.

Generally accepted accounting principles (GAAP) prescribe the principles and standards necessary to define acceptable accounting practices. GAAP and standards include not only broad guidelines of general application, but also detailed practices and procedures.

Several different organizations have been involved in establishing these principles. Prior to 1973, the Accounting Principles Board of the American Institute of Certified Public Accountants provided much of the leadership in developing standards for financial accounting and reporting. In 1973, that board was replaced by the seven member Financial Accounting Standards Board to give a new impetus to the further development of GAAP. Its members include representatives from the accounting profession, an accounting educator, a corporate financial executive and an official from the federal government. In July 1984, another body, the Governmental Accounting Standards Board, began operations. It was created to establish nationwide standards for financial accounting and reporting by state, county, and municipal governments.

Independent audits of financial statements and disclosures are vitally important to assure for the public the credibility of those statements and disclosures. Such audits must follow a generally accepted set of auditing standards and must be properly performed by competent professionals applying their professional judgment to the circumstances of the specific audit. The independent auditor is responsible for expressing an opinion, in the form of an audit report, on the fairness of the financial statements. Without the independent auditor's report, financial statements would have little meaning because the entity would be representing its financial condition and results of operations without an independent assessment for the user's protection.

GAO'S AUDITS OF GOVERNMENT CORPORATIONS

The Government Corporation Control Act (GCCA), 31 U.S.C. 9105, requires GAO to audit the financial transactions of government corporations in accordance with principles and procedures applicable to commercial corporate transactions. GAO issues reports on the financial statement's fair presentation and conformity with GAAP, and the adequacy of the entity's internal accounting controls and compliance with laws and regulations. GAO staff either directly perform financial statement audits of the entities or audit by reviewing the audit work of other independent auditors.

GAO is presently responsible for conducting audits of 49 government corporations and similar entities. The GCCA lists 22 entities as wholly owned or mixed ownership government corporations. GAO audits the other 27 entities under laws which essentially provide that GAO shall audit in accordance with principles and procedures similar to those contained in the GCCA. FDIC and FSLIC are government corporations. GAO is required to audit FDIC triennially and FSLIC annually under 31 U.S.C. 9105(a)(2). The NCUA is an independent agency and its Share Insurance Fund is not classified as a government corporation. Thus, the Fund is audited by GAO under the Fund's authorizing legislation, the Federal Credit Union Act, although the terms of the audit are like those for government corporations. GAO has been auditing these entities on an annual basis.

Some government corporations and similar entities have determined that they have statutory authority in their authorizing legislation to contract for the independent audits. At present, about 30 of the entities are audited annually by independent CPAs. In such cases, GAO discharges its statutory responsibility by reviewing the corporations' financial statements and the work of the independent auditor. GAO includes the CPA's report and the entity's financial statements, along with the results of GAO's review, in an audit report to the Congress. This avoids a duplication of effort and enables GAO to spread its limited resources among a greater number of entities.

On each of our financial audits, we determine if the financial statements are in conformance with GAAP. To the extent that the statements do not conform to GAAP, we recommend that the entity make appropriate adjustments to bring the statements into conformance. If such adjustments are not made and the amounts involved are material, our opinions are qualified due to the departures from GAAP.

PURPOSE OF THE FDIC AND FSLIC INSURANCE FUNDS

Now let me return to FDIC and FSLIC. As of December 31, 1984, FDIC insured an estimated $1,390 billion in deposits in 14,785 commercial and mutual banks, and FSLIC insured an estimated $724 billion in deposits in 3,167 savings and loan institutions. These deposit insurance funds were created primarily to restore depositors' confidence and reduce the likelihood and consequences of widespread depository institution failures. To accomplish these objectives the FDIC and FSLIC have a variety of options at their disposal to assist troubled institutions. And if an institution does fail, the FDIC or FSLIC pays off the insured depositors and then seeks recovery through liquidation (sale) of the institution's assets.

Both FDIC and FSLIC are authorized to act to prevent the failure of an insured institution. FDIC may make loans, secured in whole or part, by the assets of an insured bank; purchase any assets or guarantee any insured bank against loss by assuming the liabilities and purchasing the assets of an open bank; or arrange a merger of a failed or failing insured bank with another insured bank. FSLIC may loan or give contributions to an institution to prevent its default or it may facilitate the merger, consolidation, or acquisition of the assets of the institution.

Liquidating an insured institution

When federal or state chartering officials close an insured institution, the appropriate federal insurance authority is normally designated as the receiver. The federal insurance authority, in its corporate capacity, settles the insurance claims either by a cash payout of insured accounts or by transferring the insured accounts to another insured institution. In either situation, the insurance authority in its corporate capacity acquires the account holders' claim against the assets of the defaulted institution. In its receivership capacity, the insurance authority is then responsible for liquidating the failed institution's assets, recovering the proceeds, and making periodic cash distributions to the failed institution's creditors.

Assets being liquidated by the receiver do not appear on the depository insurers' financial statements. However, FDIC's and FSLIC's financial statements do contain line items which represent the total outstanding claims against the assets of failed institutions. To achieve a fair valuation of this amount, the financial statements should contain an allowance for possible losses on outstanding claims. The allowance represents the estimated loss to the depository insurer based on a calculation of the ultimate collectibility (net realizable value) of the assets of the failed institution being liquidated.

OVERVIEW OF GAO'S 1984 AUDITS OF FDIC AND FSLIC

GAO audited the FDIC and FSLIC as of December 31, 1984, and issued its opinions in reports to the Congress dated May 29, 1985 (GAO/AFMD-85-58), and July 16, 1985 (GAO/AFMD-85-60), respectively. We gave "qualified" opinions to FDIC and FSLIC on their 1984 financial statements indicating our concern about the value of certain assets acquired during default prevention or liquidation activities. Estimating the net realizable value, which includes an allowance for loss, is not easy, as such an estimate is likely based on less than complete information. GAO's opinion on FDIC's 1984 financial statements was qualified because FDIC management did not establish an allowance for loss related to the loans acquired from Continental Illinois National Bank and Trust Company of Chicago (Continental Bank). Our opinion on FSLIC's 1984 financial statements was qualified due to the uncertain collectibility on claims against assets acquired from three large savings and loan institutions which had failed during the year.

FDIC's 1984 FINANCIAL STATEMENTS SIGNIFICANTLY OVERSTATE THE VALUE OF ASSETS ACQUIRED FROM CONTINENTAL BANK

In GAO's opinion, FDIC's financial statements presented fairly the financial position of FDIC as of December 31, 1984, except for the lack of an allowance for loss on the $2.1 billion of poor quality loans and other assets acquired from Continental Bank as part of an assistance program. We believe the value of those assets was significantly overstated. FDIC should have recognized the probable loss in its accounts as of December 31, 1984.

Before discussing the details of FDIC's accounting for the assistance provided to Continental Bank, I will briefly discuss the financial condition of Continental Bank which led to FDIC's assistance program. It is not my intention to evaluate the merits of the decision to assist rather than liquidate Continental Bank. My purpose today is to discuss FDIC's accounting for the assistance program and whether that assistance is presented fairly in FDIC's 1984 financial statements.

Overview of problems at Continental Bank before the assistance program

The problems of Continental Bank are well known to this Subcommittee. Your September 1984 and July 1985 reports[1] detail those problems including the bank's imprudent strategies and policies of rapid growth that depended upon a strong economy in general, and the energy industry in particular, at the expense of quality loans and investments.

According to the Subcommittee's reports, during the late 1970s Continental Bank outperformed its peers in growth, earnings and market acceptance. For the 5 years ending in 1981, Continental Bank had become one of the largest corporate lenders, increasing total assets by $22.5 billion from $18.6 to $41.1 billion. Material weaknesses occurred in the bank's system of internal controls for loans (written policies and procedures to monitor and control loan activities). Significant problems with asset quality in the bank's oil and gas lending department were highlighted by the Penn Square Bank failure in July 1982. Continental Bank held about $1.1 billion of Penn Square's loans. In 1983 and 1984, significant credit worthiness and loan documentation deficiencies were revealed by bank examiners and others in Continental Bank's loan operations. As a result, more and more loans were labeled as nonperforming (at least 90 days in arrears). By June 30, 1984, nonperforming loans amounted to $2.8 billion as compared to $444 million as of January 1981.

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[1] "The Financial Performance of Continental Illinois National Bank: A Chronology and Peer Group Comparison" dated September 1984, and "Continental Illinois National Bank: Report of an Inquiry Into its Federal Supervision and Assistance" dated July 1985. Staff reports to the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House of Representatives Committee on Banking, Finance, and Urban Affairs.

The Subcommittee's reports discuss the crisis of confidence in Continental Bank that occurred in May 1984 when rumors began circulating that the bank was near insolvency. The bank experienced a serious liquidity problem resulting from the loss of a major portion of both its domestic and foreign funding base. Major providers of overnight and term funds did not renew their holdings and the bank was forced to prepay time deposits and to arrange for the replacement of certificates of deposit. Because no other adequate funding sources were available, the bank resorted to Federal Reserve Bank borrowings which rose to an average daily level of $2.6 billion.

On May 17, 1984, the FDIC, Federal Reserve, and Comptroller of the Currency announced a temporary assistance plan that also included loan participations (partial ownership in a loan or group of loans) by a number of major U.S. banks. The purpose of the plan was to stabilize the bank and provide the regulators additional time to find a permanent solution. The plan provided a $2 billion loan ($1.5 billion was provided by the FDIC with the balance provided by a group of major commercial banks) through the Federal Reserve Bank of Chicago. In addition to Federal Reserve borrowings, a consortium of 28 banks made available a $5.5 billion standby line of credit.

The permanent assistance program for Continental Bank

After FDIC attempted unsuccessfully to find a merger partner, federal regulators concluded that the only practical resolution to the problem was to have Continental Bank continue as an independent institution. To achieve this, a permanent assistance program was announced on July 26, 1984. The major components of that program included the

- --installation of a new management team,
- --infusion of $1 billion in new capital,
- --removal of $4.5 billion in problem loans, and
- --continuation of the lines of credit from the Federal Reserve and commercial banks.

The temporary assistance plan's $2 billion loan was repaid by Continental Bank.

Under the terms of the permanent assistance program, the $1 billion capital infusion was from FDIC's purchase of two new issues of Continental Illinois Corporation (the bank's holding company) preferred stock. The first issue, 32 million shares of nonvoting Junior Perpetual Convertible Preference Stock acquired for $720 million, is convertible, upon sale by FDIC to a third party, into five shares of common stock of Continental Illinois Corporation. The second issue, 11.2 million shares of nonvoting Adjustable-Rate Preferred Stock, was purchased for $280 million. This Adjustable-Rate Preferred Stock is callable at Continental Illinois Corporation's option and pays a dividend tied to the U.S. Treasury rate. During the first three years, the dividend is payable in cash or additional adjustable-rate preferred stock.

The removal of $4.5 billion in problem loans from the bank is being accomplished in several steps. In 1984, $1 billion was written off as a loss by the bank. At that time, FDIC assumed $2.0 billion of the troubled loan portfolio and accepted a promissory note from the bank for $1.5 billion payable within 3 years in cash or with additional troubled loans. As of December 31, 1984, FDIC had acquired a total of $2.1 billion in troubled loans from the bank, and as of June 30, 1985, the bank had transferred a total of $387 million in troubled loans toward the $1.5 billion promissory note. In return for the troubled assets acquired or to be acquired, FDIC assumed the bank's indebtedness to the Federal Reserve Bank of Chicago. Under the assistance agreement, FDIC will pay $3.5 billion plus interest to the Federal Reserve Bank within 5 years (by September 26, 1989) from collections, less expenses, of the troubled loans. If there is a shortfall at that time, FDIC will make up the deficiency with its own funds.

In conjunction with the loan assumption, FDIC was also granted an option to purchase up to 40 million shares of the common stock of Continental Bank's holding company, Continental Illinois Corporation. The purpose of the option is to compensate FDIC for any losses incurred from the collections on the troubled loan portfolio, including administrative costs and interest expense. If the troubled loan portfolio is not sufficient to repay the $3.5 billion Federal Reserve Bank indebtedness, then FDIC can exercise its stock option to acquire one share of common stock for every $20.00 of loss at the exercise price of $0.00001 per share. If FDIC does not suffer any loss under the permanent assistance program all remaining loans and other assets acquired will be returned to Continental Bank and the option would not be exercised.

FDIC's accounting for the permanent assistance program

In accounting for the permanent assistance program in 1984, FDIC followed generally accepted accounting principles, except for not establishing an allowance for loss on the troubled loans acquired from Continental Bank. FDIC recorded the assumed $3.5 billion indebtedness to the Federal Reserve Bank; the $1 billion investment in Continental Illinois Corporation preferred stock; the $1.5 billion promissory note received from Continental Bank; and the $2.1 billion of troubled loans received from Continental Bank as assets. FDIC did not establish an allowance for loss necessary to achieve an estimated net realizable value of the troubled loans. FDIC included a detailed footnote to the financial statements describing the substance of the permanent assistance program. Regarding the troubled loans, FDIC stated that ultimate collection was subject to significant uncertainties because of the financially troubled nature of the borrowers and the effects of general economic conditions on their industries. FDIC added that because of the complexity and the number of loans transferred, an estimate of the ultimate collectibility was not completed and, therefore, a determination had not been made as to whether any allowance for loss was necessary.

Preferred accounting treatment for the troubled loans acquired as of December 31, 1984

Generally accepted accounting principles provide that two conditions must be met for a loss contingency[2] to be charged to income as of the date of the financial statements: (1) it is probable that the asset value has been impaired and (2) the amount of the loss can be reasonably estimated. We believe those two conditions existed.

Value of the acquired troubled loans was impaired

GAO believes that FDIC will experience substantial losses from the loan portfolio acquired from Continental Bank. FDIC did not provide us access to the acquired loan portfolio. It only allowed us a limited review of the listing of borrowers. However, all of the loans were classified by bank examiners indicating that some, if not all, of the loan amounts will not be recovered. Some of the acquired loans had previously been written off by Continental Bank as partially or totally worthless. The majority of the loans transferred to FDIC are

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[2] For accounting purposes, a contingency is an existing condition, situation, or set of circumstances involving varying degrees of uncertainty that may, through one or more related future events, result in the gain or loss of an asset or the incurrence or avoidance of a liability.

in troubled segments of the economy, such as oil and gas and commercial real estate. As of June 30, 1985, 52 percent of the unpaid face value of the transferred loans were oil and gas industry related loans, and 10 percent were mortgage and real estate loans.

The probable loss could have been reasonably estimated

GAO believes that FDIC could have determined a reasonable range of probable losses associated with the troubled loan portfolio. During the federal regulator's review of Continental Bank, the loan portfolio was scrutinized by professional bank examiners and loans were categorized as "substandard," "doubtful," or "loss,"[3] each with an increasing percentage as to the estimated loss on that loan. This information was available to FDIC. In May 1985, before FDIC published its financial statements, a range of estimated loss was determined by Continental Bank. The estimated loss ranged from $551 to $774 million and was based on estimated cash collections, assumed interest rates, economic conditions, collection expenses, and collateral value. If FDIC had reported the lower amount of the range of estimated loss in its 1984 financial statements, its 1984 stated income would have been reduced by 30 percent, from $1.7 to $1.2 billion.

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[3] A "Substandard" classification is assigned to those assets inadequately protected by the current sound worth and paying capacity of the obligor, or pledged collateral, if any.

A "Doubtful" classification is assigned to those assets that have all the weaknesses inherent in an asset classified substandard and their collection or liquidation in full is highly questionable.

A "Loss" classification is assigned to those assets considered uncollectible and of such little value that their continuance as an active asset of the bank is not warranted. Loss classification does not mean that an asset has absolutely no recovery or salvage value.

We understand that FDIC is evaluating the troubled loan portfolio to determine an estimated loss. We will be assessing the adequacy of the estimated loss as part of our audit of FDIC's 1985 financial statements.

FDIC'S PUBLISHED FINANCIAL STATEMENTS EXCLUDE GAO'S AUDIT OPINION

FDIC's 1984 annual report of its operations, which included its financial statements, did not include our opinion on its financial statements. We were surprised that our audit opinion was excluded, as we had worked closely with FDIC's staff to have our opinion ready for publishing in the annual report. Although we are not aware of any legal requirement for FDIC to publish GAO's opinion in its annual report, we believe FDIC should have included our opinion to fulfill its disclosure responsibility to the Congress and other users of its annual report and financial statements. Without the independent auditor's report, the financial statements have less credibility.

Government entities, like private corporations, should include the independent auditor's opinion in their annual reports because of its value to users of their statements. In the case of FDIC, users and interested parties include commercial banks, the Congress, and the citizenry. Having an annual financial audit and reporting the results to the public is an important discharge of management's fiduciary responsibility. Including the auditor's opinion on the financial statements in FDIC's annual report provides readers and users with an independent assessment of whether the financial information is complete and reliable.

We have worked with FDIC for many years and have found the organization to be very dedicated and professional. While we have not always been in complete agreement on whether FDIC's transactions are fairly presented in its financial statements, FDIC should not withhold these differences from public disclosure.

FDIC's annual report provides the opportunity for management to comment on our audit opinion and, thereby, provide its readers with management's perspective. The Comptroller General has communicated these views to Mr. Isaac, and we hope that FDIC will include our audit opinions in its future annual reports.

FSLIC'S 1984 FINANCIAL STATEMENTS INCLUDE ASSETS OF UNCERTAIN VALUE

In GAO's opinion, FSLIC's 1984 financial statements are fairly presented subject to the uncertain net realizable value of claims against assets acquired from three large institutions--Empire Savings and Loan, Mesquite, Texas; Knox Federal Savings and Loan, Knoxville, Tennessee; and San Marino Savings and Loan, San Marino, California--that were closed in 1984. As of December 31, 1984, FSLIC held $1.3 billion in claims against the assets of the three institutions, and had established a $468 million allowance for loss based on a preliminary estimate that did not include all possible costs. The recency of the San Marino and Knox Federal failures in late 1984, along with inadequate loan records and pending and possible litigation affecting the three institutions, precluded determining a better estimate of the ultimate collectibility of the claims. Given these uncertainties, we were not able to satisfy ourselves that FSLIC's allowance for loss estimate was reasonable.

Determining the allowance for loss

As previously discussed for the troubled assets FDIC acquired (page 15), GAAP provides that an allowance for loss should be established when it is probable that an asset's value has been impaired, and the amount of the loss can be reasonably estimated. FSLIC followed that guidance in establishing the allowance for loss on the claims against the assets of Empire, Knox Federal, and San Marino.

Also, in accordance with GAAP, to establish the allowance for loss, an impaired asset should be valued on a net realizable basis. To determine net realizable value, management should consider, to the extent possible, the estimated sales price of the asset, disposition costs, direct holding costs (estimated future income and expenses), cost of funds, holding periods, and discounted cash flows.

FSLIC has a two-step process to determine an allowance for loss on claims against assets acquired from failed institutions (where FSLIC has been appointed receiver).

The first step is to calculate an estimate using a cost-to-liquidate analysis. This calculation is a preliminary estimate of the total cost FSLIC would incur should it liquidate the failing institution. It is used to determine the least costly method of dealing with the failing institution's problems. Information available for the analysis may not always be sufficient to compute the ultimate collectibility of the assets. For example, for the three failed institutions, the computation used unaudited financial data that was also several months old, and data stated on a regulatory accounting basis, which included items such as appraised equity capital not recognized by GAAP. Based on the cost-to-liquidate analysis calculation, FSLIC established a $468 million allowance for loss on the failure of Empire, Knox Federal, and San Marino. FSLIC used the allowance in its December 31, 1984, financial statements to value its claims against the assets of the three institutions.

The second step in FSLIC's process is to adjust the allowance figure based on the completion of an inventory audit of the assets being liquidated. FSLIC, as receiver, contracts with a public accounting firm for the audit. Under the terms of the contract, the firm prepares a detailed inventory schedule of all assets and liabilities, and performs an examination of the balance sheet for the receivership at the date of liquidation. The initial balance sheet audit is to be based on a net realizable value basis. The net realizable value calculation produces a more realistic amount of FSLIC's ultimate collectibility on the assets acquired than the cost-to-liquidate analysis.

As the assets are liquidated and actual experience gained on recoveries, the estimated losses are adjusted annually to reflect this experience. These revised estimates of loss are based on judgments made by the managing officer responsible for liquidating the assets of the receivership. In addition, FSLIC contracts with a public accounting firm to perform a yearly audit of the receivership's balance sheet, which includes an evaluation of the procedures followed in determining the reasonableness for the annual adjusted net realizable value.

The value of acquired assets is uncertain

As of the date of our report, FSLIC had not received a report from the public accounting firms on two of the inventory audits. In the report received (Empire), the auditors had not expressed an opinion on the net realizable value of the assets. As a result, FSLIC initially relied on a March 12, 1984, estimate arrived at by the cost-to-liquidate analysis to determine the value of the assets. The allowance for Empire was revised downward from the cost-to-liquidate amount based on the judgment of the receivership's managing officer.

According to the contracts with the public accounting firms, the inventory audits were to be completed for Empire in August 1984, Knox Federal in March 1985, and San Marino in April 1985. These dates were not met and the firms asked for and were granted extensions. To understand the problems encountered by the public accounting firms in evaluating the net realizable value of the assets, we will present an overview of the conditions that existed at each institution prior to its failure.

We obtained the following information on the three institutions from sources such as reports of examination by the Federal Home Loan Bank Board's[4] Office of Examination and Supervision, various filings by the institutions with the Securities and Exchange Commission, the financial statement and inventory audits performed by public accounting firms, and other evidence from various Federal Home Loan Bank Board divisions. The information revealed a scenario of rapid growth, primarily resulting from the use of brokered deposits (jumbo savings obtained through brokers) to fund highly speculative loans and real estate investments, and material deficiencies regarding management practices, lending policies, recordkeeping and compliance with Bank Board regulations. Several examples follow.

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[4] The Federal Home Loan Bank Board is responsible for supervision and regulation of all federally insured savings and loan institutions.

Empire's assets increased from $20 million in March 1982 to $320 million in March 1984, a 1,500 percent increase over the 2-year period. The rapid growth was based on a lending policy that created large excessive amounts of loans to purchase undeveloped land based on artificially inflated land prices. When the loans matured, construction loans were being granted that included the previous principal, loan origination fees, interest closing costs, and construction and promotional costs of the condominiums. Empire was closed on March 14, 1984.

Knox Federal was closed on November 16, 1984. The net realizable value of many assets at Knox Federal have not been obtained because of the deficient conditions that existed prior to the failure. For example,

--highly speculative and alleged fraudulent loans were extended to related parties and insider entities,

--loan underwriting was often based on appraisals that were inflated and not supported by adequate documentation and in many cases failed to meet the regulators' guidelines,

--loan files often lacked adequate documentation, and

--loans were made in excess of the value of the underlying collateral.

San Marino was closed on December 6, 1984. San Marino's total assets increased from $2 million, at the beginning of its operations in October 1979, to $840 million at its failure in late 1984. Such growth was fostered primarily by the acceptance of brokered deposits to fund aggressive real estate lending activities. For example, San Marino's financial statements at December 31, 1983, showed that 43 percent of its total assets were real estate which included construction loans and joint venture projects in various geographic locations. Also, San Marino often had an investment rather than a secured position in these projects, which complicated the net realizable value determination. Other significant uncertainties existed related to the assets pledged as collateral for the secured advances. For example, in a letter dated April 11, 1984, the Federal Home Loan Bank of San Francisco advised FSLIC that San Marino had delivered only $150.6 million worth of collateral to secure $360 million of FSLIC-guaranteed advances. Of this amount of collateral, $24.8 million constituted construction loans not normally eligible under the Bank's credit program.

Current status of the inventory audits of Empire, Knox Federal, and San Marino

Since our audit opinion was issued on May 3, 1985, information has not yet been finalized that is needed to resolve the uncertainties we addressed in our qualified opinion.

On February 22, 1985, the public accounting firm of Touche Ross & Company issued its opinion on the March 14, 1984, inventory audit of Empire. Touche Ross & Company stated that deficiencies in recordkeeping practices in Empire's accounting system plus the fact that the institution's operating management personnel were no longer employed by the receivership precluded obtaining sufficient and competent evidential matter to determine the extent to which adjustments were necessary to state the accounts in accordance with GAAP. As a result of these conditions, Touche Ross & Company did not express an opinion on the inventory audit of the assets in liquidation.

The final inventory audit reports for both San Marino and Knox Federal have not yet been issued. Price Waterhouse believes that a draft of the inventory audit of San Marino may be completed by the end of September. Deloitte, Haskins + Sells believes that its inventory audit report on Knox Federal may be finalized by mid-September. The public accounting firm stated that it will not be able to determine the net realizable value of all the assets due to substantial unresolved litigation and alleged excessive amounts of fraud and misappropriation. As a result, it will not express an opinion on the November 16, 1984, inventory audit of Knox Federal.

ERNST AND WHINNEY'S OPINIONS ON THE SEPTEMBER 30, 1984 AND 1983, FINANCIAL STATEMENTS OF THE NATIONAL CREDIT UNION SHARE INSURANCE FUND

The Share Insurance Fund, governed by the National Credit Union Administration Board insures members accounts in federal credit unions and qualifying state credit unions. The NCUA Board contracts for annual audits of the Share Insurance Fund. The public accounting firm of Ernst and Whinney conducted the 1984 and 1983 examinations. The Federal Credit Union Act (12 U.S.C. 1789(b)(2)), provides that NCUA maintain the Share Insurance Fund's accounts which shall be audited by GAO in accordance with principles and procedures applicable to commercial corporate transactions as provided in the GCCA. To avoid unnecessary expense and make the most efficient use of our available resources, we audited the Fund by reviewing Ernst and Whinney's audit and relying on it to a considerable extent, rather than duplicating the work of the firm. We have completed our review of Ernst and Whinney's examination of the 1983 Share Insurance Fund financial statements, and we are in the process of reviewing the 1984 audit.

In the opinion of Ernst and Whinney, except for (1) a departure from generally accepted accounting principles in accounting for the cumulative effect of a change in providing for estimated losses from supervised credit unions and (2) the lack of sufficient data in support of the provisions for losses from supervised credit unions, and asset and merger guarantees, the Share Insurance Fund's financial statements present fairly its financial position as of September 30, 1983, and the results of its operations for the year ended September 30, 1983, in conformity with generally accepted accounting principles applied on a consistent basis.

Except for not mentioning the absence of a statement of changes in financial position for the Share Insurance Fund, we found nothing to indicate Ernst and Whinney's opinion on the 1983 financial statements of the Share Insurance Fund are inappropriate or that they cannot be relied on.

Ernst and Whinney did not prepare the reports on internal accounting controls and compliance with laws and regulations required by generally accepted government auditing standards because its contract did not require such reports. However, Ernst and Whinney did study and evaluate internal accounting controls and test transactions for compliance with key laws and regulations. Its work did not disclose any material internal control weaknesses or noncompliance with laws and regulations.

Ernst and Whinney has reported that the 1984 financial statements of the Share Insurance Fund are fairly stated. According to the audit report, Ernst and Whinney satisfied itself that the estimated losses and the related provision for insurance losses were reasonable based on its review of the Share Insurance Fund's actual loss in 1984. The auditor's 1984 report also removed that qualification from the 1983 financial statements. The other qualification in the 1983 report, accounting for the cumulative effect of the 1983 change in providing for estimated losses from supervised credit unions, remained as a qualification on the 1983 financial statements but had no effect on the 1984 statements. GAO has not completed its review of the 1984 audit.

IMPROVING FINANCIAL MANAGEMENT IN THE FEDERAL GOVERNMENT

Before wrapping up with some observations on broader issues related to my testimony, I want to mention one of GAO's major projects--building an effective financial management structure to manage the cost of government. Government corporations are ahead of most federal departments and agencies in producing business-like financial statements to report the results of their operations and in having an audit conducted by independent auditors to attest to the reliability of the financial statements. It is GAO's long-term goal to bring about regular financial audits of the federal departments, agencies, government corporations, and the consolidated financial statements of the U.S. government. Although there are some problems with the financial statements of FDIC, FSLIC and NCUA, the financial disclosure of these entities is more useful than that for most federal agencies which do not have business-like financial statements.

GAO is trying to move the federal government toward putting its financial management systems in order, so that reliable and useful financial management information is produced and reported, and that annual independent audits are conducted to provide assurance that the financial statements are reliable. We have put together a two-volume educational document entitled "Managing the Cost of Government: Building an Effective Financial Management Structure" (GAO/AFMD-85-35) and (GAO/AFMD-85-35a), dated February 1985. Volume I outlines the major issues and problems, while the second volume provides a conceptual framework for a new system. Under this framework agencies would prepare financial statements that would be subject to an annual audit. Improved financial management is not a panacea that will solve the government's budget problems, but the benefits will provide federal policymakers with relevant and reliable information needed to manage the federal government and to inform the public on the financial condition of the government.

OBSERVATIONS

I would now like to mention what I think are some of the broader issues which my testimony has touched upon. These are (1) the financial problems facing financial institutions--thrifts in particular, (2) the riskier activities now engaged in by some financial institutions, (3) the need for full and fair public disclosure, and (4) the increasing responsibility of the auditors of financial institutions.

In today's world, prudently managing a bank or thrift institution is not an easy job. Beginning with the problems related to real estate investment trusts in the mid-1970s, financial institutions entered a decade of turmoil. The environment in which they operate has been increasingly deregulated and become far more competitive, while promising areas of growth have presented significant new risks. At the same time, the economy has shifted from growth and inflation, to one with significant business cycles, and for the past few years, relatively stable prices. The roller coaster ride of interest rates has only recently ended and there is mixed opinion on whether it will renew itself.

Large banks poured money into foreign loans and the energy sector and today they are counting their current experience with many of these loans as nonperforming assets. Smaller banks have been troubled by agricultural loans. But more so than the banks, savings and loans and mutual savings banks have encountered the most severe financial difficulties. Until the mid-1970s, thrifts operated in a relatively simple environment, obtaining deposits at artificially low rates under Regulation Q and investing in fixed rate, long-term mortgages at several percentage points higher. But when short-term interest rates skyrocketed in the early 1980s and thrifts were forced to compete for deposits in a deregulated environment, the fixed-rate mortgage became the villain as institutions were now financing these long-term investments with 15 percent certificates of deposit. As a result, 511 thrifts failed from 1980 to 1984, according to Bank Board figures.

Now a new problem has emerged--poor quality loans and investments. In order to earn a higher rate of return, some thrifts made questionable loans and direct investments which offered greater profits, but presented far greater risks. The growth of direct investment activity, in lieu of traditional debt investment, can be traced to the recent deregulation of interest rates, which increased the pressure on savings institutions to turn away from traditional low-yielding home mortgages. Recent federal and state laws triggered much of this growth by granting thrifts the authority to invest in equity securities and real estate development, among other investments. Although direct investments particularly in commercial real estate and development can be more profitable than normal investments, they also are more risky and have contributed to some of the more spectacular and potentially costly failures in recent years, including San Marino, Empire, and Beverly Hills Savings and Loan Association.

While the Bank Board has discontinued reporting the number of problem thrifts, Chairman Grey has been quite candid in his concern for the industry. In a recent report prepared by FDIC in anticipation of a merger of the deposit insurance funds, FDIC noted that institutions insured by FSLIC have tangible capital of just $6.2 billion on assets of $956 billion. Recently, the thrift industry, overall, has become more profitable due to the general decline in interest rates. However, it remains to be seen if interest rates will remain stable long enough to allow the thrift industry to absorb losses related to poor quality loans and investments and rebuild its weakened net worth position. The concern we have over asset quality remains as many of these problems are slow to be identified.

Recent work we have performed at the request of the House Subcommittee on Oversight and Investigations demonstrated that Beverly Hills' assets grew from $402 million in 1979 to nearly $2 billion by the end of 1983. The growth was largely attributable to Beverly Hills' involvement (often as an investment rather than a lender) in apartment projects, major office buildings, and hotel construction.

The Bank Board has recently observed that "The exercise of these nontraditional investment powers can expose institutions and the FSLIC to a degree of risk inconsistent with the purposes of" the laws establishing federal deposit insurance. We certainly agree and would suggest that the Subcommittee, in the course of these hearings on deposit insurance, reevaluate the insurance program--why it was set up and the type of financial institutions and product offerings it was intended to cover; and determine if certain activities of insured institutions should no longer qualify, or if some adjustment should be made to the insurance premiums these firms pay.

Finally, the need for full disclosure of nonperforming assets and the responsibilities of the independent auditor are related issues I want to briefly mention.

We are working with government corporations to improve the usefulness of their financial statements for their constituents --the Congress and the general public. There is a need for an equal focus on agency financial statements. For example, our experience with FDIC and FSLIC raises the question of what may be uncovered when the combined statements of the federal government are audited. As of September 30, 1984, total outstanding direct loans by the federal government amounted to about $225 billion, and another $400 billion in loan guarantees existed. We believe federal agencies should be preparing financial statements which are audited to increase reliability.

In similar fashion, I have concern that banks and thrifts have been far too slow to recognize the uncollectible portion of their assets. Failures of financial institutions have all too often appeared to leap upon us from nowhere. In retrospect, the failed institutions have been remiss--to be kind--in not establishing a reasonable reserve which recognizes the inherent potential loss in their loan portfolio and investment position. This is where the role of the independent auditor becomes critical.

The auditor accepts a great deal of responsibility in auditing a bank or thrift, and some recent failures have called the auditors' performance into question. I'm not sure I have the answer today, but it may involve a number of things: a closer study of the entity's internal controls in the loan function, a more conservative assessment of the methodology used to estimate losses, a closer questioning of the reserves themselves, greater sharing of information with federal and state regulators, and more disclosure about the entity's activities and risk management strategies in the notes to financial statements. Whatever the answer, auditors of financial institutions must recognize that they are auditing institutions of public trust, and conduct their audits in the most professional and responsible manner possible.

Mr. Chairman, this concludes my statement. I would be happy to address any questions the Subcommittee may have.

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Examination Of The Federal Savings And Loan Insurance Corporation's Financial Statements For The Years Ended December 31, 1984 and 1983

GAO examined the financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1984 and 1983. The examinations were made in accordance with generally accepted government auditing standards.

As of December 31, 1984, the Corporation held $1.8 billion in subrogated accounts and secured advances (claims against the assets of closed institutions). Empire, Knox Federal, and San Marino savings and loan associations account for $1.3 billion of these claims. The net amount that will be realized from the claims against these three institutions is uncertain. The Corporation has established a $468 million allowance for loss for the assets acquired from these three institutions. However, the recency of the San Marino and Knox failures, along with inadequate loan records and pending and possible litigation affecting the three institutions, precludes finalizing the estimated net realizable value of the assets.

In GAO's opinion, subject to the uncertain net realizable value of the assets acquired from Empire, Knox Federal, and San Marino, the financial statements present fairly the financial position of the Corporation as of December 31, 1984 and 1983, the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles.

Because of the many imponderables involved in forecasting the sufficiency of the insurance fund to meet future claims against it, our opinion on the financial statements does not extend to the adequacy of the fund.

UNITED STATES GENERAL ACCOUNTING OFFICE

GAO/AFMD-85-60
JULY 16, 1985

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-114893

To the President of the Senate and the
Speaker of the House of Representatives

This report presents our opinion on the Federal Savings and Loan Insurance Corporation's financial statements for the years ended December 31, 1984 and 1983. We believe the statements are fairly presented subject to the uncertain net realizable value of $1.3 billion of assets on the 1984 statements that the Corporation acquired from the failure of three insured savings and loan associations. The Corporation incurred a loss of $879 million in 1984, resulting from protecting depositors and assisting problem institutions, and could sustain future losses in subsequent accounting periods. Because of the many imponderables involved in forecasting the sufficiency of the insurance fund to meet future claims against it, our opinion on the financial statements does not extend to the adequacy of the fund. Appendix I is our report on the Corporation's system of internal accounting controls, and appendix II is our report on the Corporation's compliance with laws and regulations.

The Federal Savings and Loan Insurance Corporation is a wholly owned government corporation that is governed by the Federal Home Loan Bank Board. The Corporation is responsible for insuring the safety of savings in thrift and home financing institutions. The Comptroller General is required to audit the financial transactions of wholly owned government corporations under 31 U.S.C. 9105. We conducted our examinations in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, and the Chairman of the Federal Home Loan Bank Board.

Charles A. Bowsher
Comptroller General
of the United States

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. [illegible]

May 10, 1985

B-114893

The Honorable Edwin J. Gray
Chairman, Federal Home Loan
Bank Board

Dear Mr. Gray:

We have examined the statements of financial position of the Federal Savings and Loan Insurance Corporation as of December 31, 1984 and 1983, and the related statements of income and expense and reserves, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As of December 31, 1984, the Corporation, in its role as liquidator of failed institutions, held $1.8 billion in subrogated accounts and secured advances (claims against the assets of closed institutions). Empire Savings and Loan, Knox Federal Savings and Loan, and San Marino Savings and Loan account for $1.3 billion of these claims. The estimated net realizable value of these claims is uncertain. Although the Corporation has established a $468 million allowance for loss for the assets acquired from the three institutions, the recency of the San Marino and Knox failures, inadequate loan records, and pending and possible litigation affecting the three institutions preclude finalizing the estimated net realizable value of the assets acquired.

In our opinion, subject to the uncertain value of the $1.3 billion of assets on the 1984 statements that the Corporation acquired from the three failed insured savings and loan institutions, the financial statements referred to above present fairly the financial position of the Federal Savings and Loan Insurance Corporation as of December 31, 1984 and 1983, and the results of its operations and changes in financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

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In 1984, the Corporation incurred a loss of $879 million resulting from protecting depositors and assisting problem institutions, and could sustain future losses in subsequent periods. The savings and loan industry has been thinly capitalized and confronted by narrow interest rate margins and poor quality loans and investments. As of December 31, 1984, the Corporation had reserves of about $5.6 billion, and as discussed in note 11 to the financial statements, as of March 31, 1985, the Corporation had obtained a special assessment totaling $245 million from all federally insured institutions to strengthen the insurance fund. Because of the many imponderables involved in forecasting the sufficiency of the insurance fund to meet future claims against it, our opinion on the financial statements does not extend to the adequacy of the fund.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

Appendixes

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REPORT ON INTERNAL ACCOUNTING CONTROLS

We have examined the financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1984 and 1983, and have issued our opinion thereon. As part of our examinations, we made a study and evaluation of the system of internal accounting controls to the extent we considered necessary to evaluate the system as required by generally accepted government auditing standards. This report pertains only to our study and evaluation of internal accounting controls for the year ended December 31, 1984. (Our report on the system of internal accounting controls for the year ended December 31, 1983 is presented in GAO/AFMD-84-47, 5/30/84.) For the purpose of this report, we have classified the significant internal accounting controls in the following categories:

--assistance to problem savings and loan associations,

--expenditures,

--financial reporting,

--insurance premiums, and

--investments.

Our study included all of the control categories listed above. However, we did not evaluate the accounting controls over assistance to problem savings and loan associations, financial reporting, and investments because it was more efficient to expand substantive audit tests. The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the Corporation's financial statements. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting controls taken as a whole or on any of the categories of controls identified above.

The management of the Federal Savings and Loan Insurance Corporation is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of the inherent limitations in any system of internal control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation was made for the limited purpose described in the first paragraph and would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting controls of the Federal Savings and Loan Insurance Corporation taken as a whole or on any of the categories of controls identified in the first paragraph. However, our study and evaluation disclosed no condition that we believed to be a material weakness.

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

We have examined the financial statements of the Federal Savings and Loan Insurance Corporation for the years ended December 31, 1984 and 1983, and have issued our opinion thereon. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures, including tests of compliance with laws and regulations, as we considered necessary in the circumstances. This report pertains only to our review of compliance with laws and regulations for the year ended December 31, 1984. (Our report on compliance with laws and regulations for the year ended December 31, 1983, is presented in GAO/AFMD-84-47, 5/30/84.)

In our opinion, the Corporation complied with the terms and provisions of laws and regulations for the transactions tested that could have materially affected the financial statements.

Nothing came to our attention in connection with our examination that caused us to believe that the Corporation was not in compliance with the terms and provisions of applicable laws and regulations for those transactions not tested.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
COMPARATIVE STATEMENT OF CONDITION
DECEMBER 31, 1984 AND 1983

	1984	1983
Assets		
Cash	$ 2,764,236	$ 1,160,313
Insurance Premiums and Accounts Receivable	37,803,382	46,336,719
Investments (Note 2)	5,869,307,301	6,799,195 381
Interest Receivable on Investments	58,296,395	70,840,669
Loans to Insured Institutions (Note 7)	922,349,947	208,749,278
Interest Receivable on Loans to Insured Institutions.	4,157,244	3,433,918
Subrogated Accounts in Insured Institutions	1,156,502,895	351,876,053
Less: Allowance for Possible Future Losses	642,597,193	108,800,000
Net Subrogated Accounts (Note 3)	513,905,702	243,076,053
Income Capital and Net Worth Certificates	865,163,795	850,100,000
Dividends Receivable on Net Worth Certificates	526,598	260,572
Less: Allowance for Possible Future Losses	146,857,000	101,500,000
Net Income Capital and Net Worth Certificates (Note 5)	718,833,393	748,860,572
Secured Advances Due from Receiver	642,809,038	-0-
Less: Allowance for Possible Future Losses	60,127,729	-0-
Net Secured Advances Due from Receiver (Note 8)	582,681,309	-0-
Mortgage Loans and Real Estate	297,246,914	253,277,765
Less: Allowance for Possible Future Losses	69,758,005	27,638,989
Net Mortgage Loans and Real Estate	227,488,909	225,638,776
Total Assets	8,937,587,818	8,347,291,679
Liabilities and Reserves		
Accounts Payable and Other Liabilities	55,679,776	33,358,958
Notes Payable to FHLBanks (Note 7)	700,000,000	-0-
Notes Payable to Insured Institutions (Note 6)	834,834,936	842,603,148
Accrued Interest on Notes Payable	35,044,537	38,325,995
Allowance for Possible Future Losses Under Contribution Agreements (Note 4)	1,706,261,101	1,007,582,054
Primary Reserve (Note 9)	4,885,037,594	5,764,260,686
Secondary Reserve (Note 9)	720,729,874	661,160,838
Total Liabilities and Reserves	$ 8,937,587,818	$ 8,347,291,679

The accompanying notes are an integral part of these financial statements.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
COMPARATIVE STATEMENT OF INCOME AND EXPENSE AND RESERVES
FOR THE YEARS ENDED DECEMBER 31, 1984 AND 1983

	1984	1983
Income		
Insurance Premiums (Note 1)	$ 596,940,890	$ 508,491,095
Interest on Investments	655,265,644	604,655,968
Interest on Loans to Insured Institutions	42,396,735	20,200,094
Income on Mortage Loans and Real Estate	18,412,484	28,194,774
Other Income	11,962,043	931,050
Total Income	1,324,977,796	1,162,472,981
Expenses		
Administrative Expenses	1,233,731	1,076,727
Net Loss on Sale of Securities	-0-	17,887,091
Services Rendered by The Federal Home Loan Bank Board (Note 8)	28,365,685	30,276,417
Interest on Notes Payable to FHLBanks	23,785,879	-0-
Interest on Notes Payable to Insured Institutions	89,458,494	66,662,590
Insurance Settlement and Other Expenses	21,666,975	16,928,393
Provision for Possible Future Losses on:		
Contribution Agreements (Note 4)	1,293,503,676	895,178,263
Mortgage Loans and Real Estate	62,771,576	5,000,000
Income Capital and Net Worth Certificates.	45,357,000	(68,400,000)
Subrogated Accounts (Note 3)	516,764,330	103,038,249
Secured Advances Due from Receiver	60,127,729	-0-
Total Expenses	2,143,035,075	1,067,647,730
Net Income (Loss) From Operations	(818,057,279)	94,825,251
Interest Applied to the Secondary Reserve (Note 9)	61,165,813	47,758,026
Net Income (Loss)	(879,223,092)	47,067,225
Reserves at Beginning of Year	6,425,421,524	5,330,843,117
Increase to Secondary Reserve	59,569,036	47,511,182
Reserves at End of Year (Note 9)	$ 5,605,767,468	$ 6,425,421,524

The accompanying notes are an integral part of these financial statements.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE YEARS ENDED DECEMBER 31, 1984 AND 1983

	1984	1983
Source of Funds:		
Net Income (Loss)	$ (879,223,092)	$ 47,067,225
Add (deduct) Items not Requiring, or Generating Cash:		
Depreciation of F&E	27,019	16,559
Provision for Possible Future Losses on:		
Mortgage Loans and Real Estate	62,771,576	5,000,000
Income Capital and Net Worth Certificates	45,357,000	(68,400,000)
Contribution Agreements	1,293,503,676	895,178,263
Subrogated Accounts	533,797,193	108,800,000
Secured Advances Due from Receiver	60,127,729	-0-
Return on Secondary Reserve	61,165,813	47,758,026
Transfer from Secondary Reserve	(1,438,798)	(189,802)
Accretion and Amortization on Investments	(26,341,231)	(96,597,810)
Funds Provided from Operations	1,149,746,885	938,632,461
Increase (Decrease) in:		
Notes Payable - to FHLBanks	700,000,000	-0-
Accounts Payable and Other Liabilities	22,320,818	7,977,931
Decrease (Increase) in:		
Investments and Interest Receivable	967,451,610	(313,971,377)
Accounts and Dividends Receivable	8,267,311	(23,655,880)
Total	2,847,786,624	608,983,135
Application of Funds:		
Increase (Decrease) in:		
Subrogated Accounts	804,626,842	253,427,622
Income Capital & Net Worth Certificates	15,063,795	408,300,000
Amount Paid Under Contribution Agreements	594,824,629	592,954,336
Refund of Secondary Reserve	157,979	57,042
Secured Advances Due from Receiver	642,809,038	-0-
Loans to Insured Institutions and Interest Receivable	714,323,995	(134,239,374)
Mortgage Loans and Real Estate	63,326,753	(105,807,758)
Decrease (Increase) in		
Notes Payable and Accrued Interest	11,049,670	(406,666,414)
Total	2,846,182,701	608,025,454
Increase in Cash	$ 1,603,923	$ 957,681

The accompanying notes are an integral part of these financial statements.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1984 AND 1983

1. Summary of Significant Accounting Policies:

    a) Income Recognition - Insurance Premium Income is recognized as earned when member institutions are assessed.

    b) Generally the Provision for Possible Future Losses is recorded when a default prevention action is taken.

2. Investments - Investment securities are stated at cost, adjusted for amortization of premiums and accretion of discounts. Such amortization and accretion are computed or the level yield method at rates based upon the lives of the related securities. Both amortization and accretions are recognized as an adjustment to Interest on Investments.

    All cash received by the Corporation which is not used to defray operating expenses or for outlays related to assistance to insured institutions and liquidation activities, is invested in U.S. Treasury securities. Other obligations are mostly securities issued by Federal Government Agencies other than the U.S. Treasury which were obtained through the Corporation's default prevention activities. As of December 31, 1984 and 1983, the Corporation's investment portfolio consisted of the following:

	1984		1983	
	Book Value (in thousands)	Market Value	Book Value (in thousands)	Market Value
U.S. Treasury Obligations:				
Overnight Funds	$ 2,334,219	$ 2,334,219	$ 1,946,558	$ 1,946,558
Maturities up to One Year	542,497	545,407	1,488,841	1,484,025
Maturities Over One Year	2,164,708	1,881,044	2,491,754	2,118,038
Subtotal:	5,041,424	4,760,670	5,927,153	5,548,621
Other Obligations:				
Maturities Up to One Year	125	119	-0-	-0-
Maturities Over One Year	827,758	756,045	872,042	802,804
Subtotal:	827,883	756,164	872,042	802,804
Total:	$ 5,869,307	$ 5,516,834	$ 6,799,195	$ 6,351,425

3. Subrogated Accounts - As required by Statute, the FSLIC closes institutions only when there is no default prevention measure that would be less costly than liquidation. In these cases, FSLIC settles insurance claims either by cash payout of insured accounts or by transferring insured accounts to another insured institution. In either case insurance payment is made in exchange for the account holder's claim against the assets of the defaulted institution. Subrogated Accounts represent the total of these outstanding claims. The changes in the Allowance for Possible Future Losses on Subrogated Accounts for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of Year	$ 108,800	$ -0-
Add: Net Provision Charged to Expense	516,764	103,038
Net Premiums	17,033	5,762
Balance, End of Year	$ 642,597	$ 108,800

4. Contribution Agreements - The FSLIC makes contribution agreements to prevent default of an insured institution. Under some of these agreements the Corporation agrees to make, or commits itself to make, certain contributions over time. The FSLIC may incur additional contingent liabilities in excess of Possible Future Losses resulting from uncertainties concerning litigation and other undisclosed liabilities. However, it is management's opinion that these amounts cannot be reasonably estimated. The changes in the Allowance for Possible Future Losses Under Contribution Agreements for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of Year	$ 1,007,582	$ 705,358
Add: Provision Charged to Expense	1,293,504	895,178
Less: Contributions Paid	594,825	592,954
Balance, End of Year	$ 1,706,261	$ 1,007,582

5. Income Capital & Net Worth Certificates - Since 1981 the FSLIC has purchased Income Capital Certificates (ICC's) from insured institutions. The FSLIC records the ICC's at cost. The ICC's earn annual income payments based on the United States Treasury Bill rates. The annual income payments and principal are redeemable upon the issuing institution having profitable operations and attaining a specified net worth level. The changes in the ICC's for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of Year	$ 773,200	$ 404,300
Add: Net Purchases (Decrease) During Year	(52,586)	368,900
	720,614	773,200
Less: Allowance for Possible Future Losses (Cumulative)	142,857	92,750
Balance, End of Year	$ 577,757	$ 680,450

5. (Con't)

In addition, since 1982 the FSLIC has purchased Net Worth Certificates (NWC's) from insured institutions as part of its default prevention activities. NWC's earn annual income payments based on the cost of Federal Home Loan Bank System Obligations plus 1/4 of one percent. Annual income and principal payments are redeemable upon the issuing institution having profitable operations and attaining a specified net worth level. Such payments have been accrued for institutions meeting these requirements. The changes in the NWC's for the years ended December 31, 1984 and 1983 are:

	1984	1983
	(in thousands)	
Balance, Beginning of Year	$ 76,900	$ 37,500
Add: Purchases During Year	67,650	39,400
	144,550	76,900
Add: Dividends Receivable	526	261
Less: Allowance for Possible Future Losses (Cumulative)	4,000	8,750
Balance, End of Year	$141,076	$ 68,411

6. Notes Payable to Insured Institutions - The FSLIC has outstanding negotiable notes to purchase ICC's and promissory notes to purchase ICC's and NWC's in the amount of $536,450,000 as of December 31, 1984, and $776,900,000 as of December 31, 1983. Variable interest is paid semiannually based on the cost of Federal Home Loan Bank System Obligations or the average auction yield for United States Treasury Notes with maturities from 5-10 years. In addition to issuing notes to purchase ICC's and NWC's, the FSLIC has also issued other negotiable notes to carry out it default prevention activities in the amount of $298,384,936 as of December 31, 1984, and $65,703,148 as of December 31, 1983.

7. Loans to Insured Institutions - The FSLIC has made loans to insured institutions on occasion as part of its default prevention activities. The outstanding balance of these loans at December 31, 1984 and 1983 were $922,349,947 and $208,749,278, respectively. The majority of the increase was a $700,000,000 collateralized loan to an insured institution.

   In order to finance the loan to an insured institution, FSLIC issued a $700,000,000 collateralized note to a FHLBank. Interest on the note is based on the cost of funds of the FHLBank plus twenty basis points. Interest on the loan is based on the monthly weighted average cost of funds charged to members of the FHLBank in which the insured institution is located.

8. Related Party Transactions - The Federal Home Loan Bank Board is an independent Federal agency in the executive branch of government and governs the Federal Savings and Loan Insurance Corporation (FSLIC). The Bank Board assessed the FSLIC for services rendered in the amount of $28,365,685 for 1984 and $30,276,417 for 1983. The principal function of the FSLIC is to insure accounts in savings and loan associations and federal mutual savings banks.

8. (Con't)

In addition, the FSLIC, as part of its default prevention activities, may guarantee repayment of FHLBank advances that were made to certain insured institutions. These guarantees are typically granted on a short-term basis, generally covering advances that are secured. The amount of these advances as of December 31, 1984, totaled $1,715 million and $559 million at December 31, 1983. In the event that it is called upon to honor these guarantees, the FSLIC has claim against any assets pledged as collateral to secure such advances. The FSLIC honored $642,809,038 of guaranteed advances during 1984 and exercised its claim to the assets securing these advances. An allowance for possible future losses in the amount of $60,127,729 was also established.

9. Reserves - The FSLIC's total reserves available for losses consist of the Primary and Secondary Reserves. The Secondary Reserve is the equity of certain institutions in FSLIC based on premium prepayments and related interest not yet paid to these institutions. It is available for losses, but may also be paid back to the institutions depending on FSLIC's financial condition and management's anticipation of losses. Interest of $61,165,813 was credited to the Secondary Reserve based on the yield of FSLIC's investment portfolio. The Primary Reserve is the cumulative net income of the FSLIC since its inception less the interest applied to the Secondary Reserve.

	1984	1983
Primary Reserve		
Balance, Beginning of Year	$ 5,764,260,686	$ 5,693,669,737
Prior Period Adjustments	-0-	23,523,724
As Restated	5,764,260,686	5,717,193,461
Net Income (Loss)	(879,223,092)	47,067,225
Balance, End of Year	4,885,037,594	5,764,260,686
Secondary Reserve		
Balance, Beginning of Year	661,160,838	613,649,656
Interest Applied	61,165,813	47,758,026
Transfers and Refunds	(1,596,777)	(246,844)
Balance, End of Year	720,729,874	661,160,838
Total Reserves at End of Year	$ 5,605,767,468	$ 6,425,421,524

10. Retirement Plan - All permanent, full-time and part-time employees who were employed by the FSLIC prior to January 1, 1984, are covered by the contributory Civil Service Retirement Plan. The Corporation makes bi-weekly contributions to the plan equal to the employee's bi-weekly contributions. Employees hired after January 1, 1984 fall under the Social Security Act; however, they also contribute 1.3% and the Corporation 7% to the Civil Service Retirement Plan. The retirement plan expense incurred for calendar years 1984 and 1983 were $258,366 and $241,567 respectively.

11. Given the state of the economy and present condition of the industry, it is possible that FSLIC could sustain additional losses in subsequent accounting periods due to its default prevention actions. Because many of the causes for default are beyond managment's control, the amount of these losses cannot be determined. However, the Corporation believes that its resources, including the right to increase insurance premiums, are sufficient to absorb any such losses over the foreseeable future.

11. (Con't)

The Federal Home Loan Bank Board, as the operating head of FSLIC, on February 22, 1985, authorized FSLIC to assess each insured institution an additional premium for insurance in an amount equal to one-thirty second of one per centum of the total amount of the accounts of the members of each insured institution determined as of December 31, 1984. The additional $245 million insurance premium assessed was paid by each insured institution on or about March 31, 1985. The Bank Board also expressed its intention to consider the assessment of further additional premiums in amounts equal to one thirty second of one per centum on a quarterly basis during 1985. If adopted, such assessments would increase income by an additional $750 million.

(916584)

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-114831

August 16, 1985

The Honorable William M. Isaac
Chairman, Federal Deposit Insurance
  Corporation

Dear Mr. Isaac:

I was surprised to learn that you did not include our opinion on the Federal Deposit Insurance Corporation's (FDIC's) 1984 financial statements in your annual report. During the course of our audit, we were aware of FDIC's schedule for printing your annual report, and we made sure that our opinion was delivered by the deadline established by your staff.

Government corporations, like private corporations, should include the independent auditor's opinion in their annual reports because of its value to those having financial interests in the corporations. In the case of FDIC, interested parties include commercial banks, the Congress, and the citizenry. I am sure you will agree that our respective responsibilities require both the FDIC and the General Accounting Office to encourage complete, accurate, and timely financial disclosure.

Having an annual financial audit and reporting the results to the public is an important discharge of management's fiduciary and disclosure responsibilities. Including the auditor's opinion on the financial statements in FDIC's annual report provides readers and users with an independent assessment of whether the financial information is complete and reliable. While our report to the Congress includes our opinion and is available to the public, it does not get the same broad exposure as FDIC's annual report. Also, our separate report to the Congress is not a substitute for FDIC's responsibility to the banking community and the public at large.

We have worked with FDIC for many years and have found your organization to be very dedicated and professional. While we have not always been in complete agreement on whether FDIC's transactions are fairly presented in its financial statements, these differences should not be withheld from public disclosure.

The FDIC annual report provides the opportunity for management to comment on our opinion and, thereby, provide its readers with management's perspective. I hope that FDIC will include our opinion in its report in the future.

If you wish, I would be glad to discuss this matter with you further.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

cc: The Honorable Fernand J. St Germain
Chairman, House Committee on Banking, Finance and Urban Affairs

The Honorable Jake Garn
Chairman, Senate Committee on Banking, Housing and Urban Affairs

The Honorable Jack Brooks
Chairman, House Committee on Government Operations

The Honorable William V. Roth, Jr.
Chairman, Senate Committee on Governmental Affairs

Bank Letter

A publication of Institutional Investor

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Vol. IX, No. 28 July 15, 1985

FDIC GETS QUALIFIED OPINION OVER CONTILLY LOANS.

The General Accounting Office has given a qualified opinion on the Federal Deposit Insurance Corp.'s 1984 annual financial report because the agency failed to include a reserve for losses on the $2.1 billion in troubled loans it acquired from Continental Illinois National Bank & Trust. FDIC addressed the omission in a footnote by saying it did not have enough time to make an estimate. The agency will include a reserve in the 1985 report, a spokeswoman said.

An auditor has three options when analyzing financial statements. It can offer a clean opinion that the statement represents fairly the financial condition of the company. It can also qualify its

(cont'd. on page 2)

TURNER SUIT BLASTS CBS ON LOAN COVENANT.

Turner Broadcasting System claims that CBS Inc. is trying to entrench management and ignore the interests of shareholders by including in a recently established $1.5 billion credit a covenant under which major changes in CBS' board would constitute a default. The claim was one of several made in a lawsuit filed in U.S. District Court in northern Georgia last April alleging that CBS ignored the best interests of the company's shareholders. Turner Broadcasting is trying to take control of CBS in a stock-and-debenture transaction, but the network has proposed its own $955 million recapitalization plan.

Turner's claim about the loan convenant was revealed in a filing

(cont'd. on page 10)

SECPAC APPLIES TO BROKER INSURANCE INTERNATIONALLY.

Security Pacific National Bank has asked the Federal Reserve for permission to broker insurance internationally from the United States through its Edge Act subsidiary, Security Pacific International Bank, according to bank and Fed officials. Bank of America has made a similar application, which was anticipated *(BL, 3/11)*. The two California banks are trying to move swiftly into a new line of business that was pioneered by Citibank.

Citi last February was the first bank given Fed approval to broker international insurance from the United States. U.S. banks can already broker insurance from certain countries like England but run afoul of federal and state law when they try to broker insurance

(cont'd. on page 9)

EURONOTE FACILITIES--A GUIDE FOR THE PERPLEXED.

When is a GUN not a weapon, a SNIF not a cold symptom and a BONUS not a reward for a job well done? When it is one of a dazzling array of acronyms coined by commercial and investment banks to market Euronote facilities, which are emerging as an increasingly popular and less costly alternative to domestic commercial paper or standby lines of credit.

But as catchy as the names are, they can also cause confusion. Asked to define a GUN, one banker replied, "If you find out what it is, I'd love to know."

And despite their imaginative names, these Euronote facilities,

(cont'd. on page 9)

INSURANCE AGENTS LANGUISH IN 1ST TENNESSEE BRANCHES. The first six months of First Tennessee Bank's pioneering arrangement to lease space in its branches to Craddock Insurance "were a dog," said Joan Tonning, director of marketing. Agents were placed in seven branches but have sold few policies. "We have learned that people are not going to rush in off the streets in order to buy insurance," said James Crews, exec. v.p.-retail. Officials declined to say precisely how few policies were sold.

Craddock originally intended to sell insurance through the mail and by telephone to bank customers in tandem with its branch efforts. However, the state insurance department delayed that strategy by withholding its approval of the mail and telephone plans until May.

Crews said the bank was still committed to insurance and believed that the combined branch, mail and telephone approach would work. The bank collects 3.8% of premiums on each policy. Crews said he believes that insurance income will ultimately amount to 10% of its non-interest retail income, or $3.5 million a year, based on last year's figures.

Crews also said the branch effort will improve with time. "It's a question of getting habits to change," he said.

IRS RULING COULD HELP LEVERAGED BUYOUT MARKET FOR BANKS. The Internal Revenue Service has indicated that it will consider most convertible debentures issued to finance leveraged buyouts to be debt rather than equity for tax purposes. The action, which came in a recent letter ruling, could bring in new business for commercial banks, which often provide much of the financing for lbos. Uncertainty over the deductibility of interest payments on convertible debt in leveraged buyouts and other tax issues have scuttled deals in the past, according to Robert Willens, a partner at Peat Marwick Mitchell.

In the past, most advisors have been unable to predict whether convertible debt issued in an lbo would be taxed as equity or debt. The distinction is important because the cash flow projections of many lbos are based on the ability to deduct interest payments to debt holders. Convertible debt is often issued to finance lbos in order to give holders the chance to gain an equity stake in the company.

"This goes a long way," Willens said about the IRS stance. "The next time I'm involved in an lbo, I'll be able to point to this ruling," he added. Most investment bankers were unaware of the ruling, but one confirmed that uncertainty over the taxation of convertible debt can be "catastrophic" to a deal.

IRS letter rulings aren't binding, but are closely scrutinized by tax specialists as clues to the thinking of the IRS. In 1969, the IRS was directed by Congress to set up ways to define whether certain financing instruments are debt or equity. Once the IRS finally developed the regulations in 1980, they proved so controversial they were never implemented so tax specialists have been at loss about how the IRS would rule in areas such as lbo financing.

FDIC GETS...
(cont'd. from page 1)

statement, in which it disagrees with the accounting methods used by the client in specific instances. Or it can decide not to issue an opinion, which forces the company to find a new auditor or restate its financial statements to conform with generally accepted accounting principles.

The FDIC declined to publish in its report the qualified statement from the GAO which is Congress' watchdog arm, because of the dispute, the spokeswoman said. In the past, the FDIC has always included the GAO's letter, although it was not required. This year, "the opinion looked bad for us, so why should we pay for the paper to print it on if we don't have to?" an FDIC official said.

As part of the federal rescue of Contilly, the FDIC agreed to acquire $2.1 billion in bad loans and could assume $1.4 billion more in loans from the bank, which came close to failing last year. Continental Illinois Holding--a corporation set up during the rescue--estimated in its annual report that the $2.1 billion in loans could cause a $551-775 million loss for the FDIC.

Gary Bowser, senior evaluator at GAO, said the FDIC should use those figures if it did not have enough time to develop its own. An FDIC spokeswoman said the agency preferred to arrive at its own figures rather than Contilly's. Regardless, Congress has been sent a copy of the GAO's qualified letter.

Continental Illinois Holding, which holds about 40 million Continental Illinois shares made the loss estimate because the FDIC has the right to take one share of Continental Illinois stock out of the holding corporation for each $20 of loan losses. Therefore, if the FDIC loses money, so will the owners of the shares currently being held by the holding corporation.

Bank Letter

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Chairman **St Germain**. Mr. Wolf, with regard to that last sentence, you said a greater sharing of information with Federal and State regulators?

Mr. **Wolf**. Yes, sir.

Chairman **St Germain**. A greater sharing, by whom?

Mr. **Wolf**. Between those regulators and the auditing firms auditing institutions, banks, savings and loans.

Chairman **St Germain**. Mr. Stearns, you heard Mr. Wolf mention the fact that in the case of Beverly Hills and San Marino, that there was a question as to whether they were loans or investments.

Does the FSLIC have a problem making that determination as well?

Mr. **Stearns**. No, sir, not usually.

Chairman **St Germain**. If that be the case, was the FSLIC aware all along of the fact that these were investments and not loans that were being made by Beverly Hills and San Marino?

Mr. **Stearns**. I think part of the problem that you have here is your lag time between examinations, that our people the State regulators, undertake, finding what loans or investments are out there, and when you are talking about a growth the way those two grew, your lag time is significant.

A significant number of loans or investments were made before we have examinations, or before the examination results were received.

Chairman **St Germain**. San Marino and Beverly Hills, are they both State-chartered institutions?

Mr. **Stearns**. Yes, sir.

Chairman **St Germain**. Therefore, the responsibility there lay with the State examiners from the great State of California?

Mr. **Stearns**. Yes, sir.

Chairman **St Germain**. That allows State-chartered thrifts to invest in anything they wish to, probably with no restrictions whatsoever, isn't that correct?

Mr. **Stearns**. Yes, sir.

Chairman **St Germain**. Do you know how often the State of California examined Beverly Hills and San Marino?

Mr. **Stearns**. No, I don't. I know they are very short handed, and the chairman has had a number of discussions with them concerning the bolstering of both California and Texas State regulators.

Chairman **St Germain**. Examiners?

Mr. **Stearns**. Yes.

Chairman **St Germain**. Do you know how many examiners they have in California?

Mr. **Stearns**. No.

Chairman **St Germain**. Do any of your very, very able and competent—what do you call them—conferees—from the Federal Home Loan Bank Board and FSLIC?

Mr. **Stearns**. Mr. Raiden informs me that he believes that the California staff has declined significantly in the last 3 years from perhaps as many as 150 down to around 68.

Chairman **St Germain**. They give them additional powers to do anything under the sun, which would ordinarily signify that, if that be the case, these S&Ls are going to be given this much additional leeway and freedom. In addition, shouldn't there be a responsibility on the part of the State of California to concurrently beef up, not only in the terms of numbers, but in terms of ability, the examining staff?

Mr. **Stearns**. Yes, sir, the chairman has had a number of discussions with the State on that, as well as the State of Texas, where we have the same problem.

Chairman **St Germain**. I am hoping that our California members of the committee, and Texas members, of both this committee and the Rules Committee, will be paying attention to this, because whenever you try to do something in this area, particularly the Texans, they go up like spaceshots. You would think that they were going into space, going with Senator Garn. They get so upset, and they say, "My gosh, don't touch Texas."

Don't get me wrong, I love Texas and Texans, but this should be disturbing to all of us.

Mr. Poling, let me ask you something, in an issue of Bank Letter—it is not a bible, because, although they quote me all the time, and I laugh at what they tell the public I am thinking or contemplating because it is so far off target, but in this instance, in the July 15, 1985, issue, an article comments that:

"The FDIC declined to publish in its report the qualified statement from the GAO, which is Congress' watchdog arm, because of this dispute, the spokeswoman said, 'Dispute being whether or not' "—the one we have discussed already slightly this morning, and will discuss more fully, Mr. Poling, so you might as well relax.

We will enjoy it. The issue is whether or not you should have included the GAO letter, which is not too complimentary as far as the Continental Illinois liability, or potential loss is concerned, in the report.

I have read the correspondence from Chairman Isaac, believe me, every word very carefully.

He is very good with letters, and press releases—Continental Illinois; remember that one? He said that no one would lose any money, but he didn't say that the FDIC would pay off over $100,000.

Next sentence, "In the past, the FDIC has also included the GAO's letter, although it was not required."

Is that accurate?

Mr. **Poling**. We have included the GAO letter since 1981, by custom.

Chairman **St Germain**. Even though it wasn't required, you included it?

Mr. **Poling**. Yes, sir.

Chairman **St Germain**. "This year, the opinion looked bad for us, so why should we pay for the paper to print it on if we don't have to?" An FDIC official, asked that question.

You included it in the past. You don't dispute that; do you?

Mr. **Poling**. No.

Chairman **St Germain**. You don't dispute the fact that the letter is not too complimentary?

Mr. **Poling**. It is a qualified opinion. We have qualified our financial statements in the same manner.

Chairman **St Germain**. You can't dispute the fact that, I will repeat, "the opinion looked bad for us."

Mr. **Poling**. Well, reasonable people can have reasonable differences of opinion in the accounting area, especially. I don't think it looks bad at all.

Chairman **St Germain**. Well, then, why was it not included? You think——

Mr. **Poling**. To connect the two incidents is inaccurate. We did not put it in or include it in our annual report, simply because of a publication contract we had in printing. There was no intent to connect that with the qualified opinion.

If we had had the opinion, we are talking about early May now, for a year-end report.

Chairman **St Germain**. Excuse me. Mr. Wolf, did your letter arrive late at the FDIC? Were you tardy?

Mr. **Wolf**. As far as we know, we were not. We had a number of conversations with the FDIC, and had a deadline when it was supposed to be delivered. We met that deadline and were told that was fine.

Chairman **St Germain**. Well, we will never know, will we, Mr. Poling and Mr. Wolf? It is problematical.

Mr. **Poling**. It has become an issue. I assure you, it will not in the future.

Chairman **St Germain**. Mr. Annunzio.

Mr. **Annunzio**. No questions at this time.

Chairman **St Germain**. Mr. Barnard?

Mr. **Barnard**. Thank you, Mr. Chairman.

Mr. Stearns, I think I need to pick up where I left off yesterday on a question having to do with a procedure where by the FSLIC guarantees savings and loan loans from the Home Loan Bank Board, and I was confused yesterday as to that procedure.

How long has this practice been going on, or has this policy been in effect?

Mr. **Stearns**. Advances or loans now?

Mr. **Barnard**. Loans.

Mr. **Stearns**. Well, to date, we have guaranteed certain loans. I think what you are referring to is the passthrough loan situation; is that correct?

Mr. **Barnard**. In other words, whether savings and loans want to borrow money from the District Home Loan Bank Board, do not have enough collateral, and the FSLIC, to accommodate the savings and loan, guarantees the loan from the Home Loan Bank Board.

Is that the way the procedure works?

Mr. **Stearns**. That is a straight guarantee. There are two different varieties. The question that you raised yesterday when Mr. Hemel referred to the situation out in one of our bank districts.

Mr. **Barnard**. No, not particularly. Really, how much are your off-balance sheet liabilities? As I understand it, and I don't have any figures with me today, but I understand that in 1983, the statement was made by the FSLIC that there was no appreciable liability in regards to that, and at your balance sheet at the end of 1983, it was upward of $2 or $300 million, and it increased in 1984.

So, I think the concern that I have, and I would suggest that the committee has also, if this procedure is going to continue, how great will that liability become, and should it be anticipated?

Then, of course, there is a second part of that question, and that is, why did the Home Loan Bank Board turn down an institution in Chicago?

Mr. **Stearns**. Those are two questions. We have guaranteed presently approximately $2.5 billion of advances, and they are an off-balance sheet guarantee.

Mr. **Barnard**. Total man?

Mr. **Stearns**. They might be included in that package.

Mr. **Barnard**. $2.5 million?

Mr. **Stearns**. Billion. Those loans are largely secured, guaranteed for one particular reason or another, and they are off-balance sheet, because we have had almost no losses whatsoever to this point on the repayment of those particular loans.

Concerning the situation in Chicago, there was a proposal discussed within the Bank Board to proceed with a passthrough loan for one of our institutions, but the Bank Board did not act on it, and it never went to the particular Federal home loan bank out there.

Mr. **Barnard**. That is not a difference of opinion as to whether or not this procedure would be continued?

Mr. **Stearns**. No, sir, had the Bank Board recommended proceeding with this particular loan, it was our understanding that it would have been approved, but we never did proceed with it, for a number of reasons.

Mr. **Barnard**. When you estimate the percentage of reserves to outstandings, how are these contingent liabilities accounted for?

In other words, when we see those figures published that the reserves of the FDIC—we will talk about FSLIC at this point—when the reserves are 0.75 or 0.85 or 1 percent of total deposits, what figures are used in arriving at those reserves?

Mr. **Stearns**. Well, you have a breakdown here of a number of things. What we look at closely are two areas. One is the primary reserve number, which stood at $5.8 billion at the end of July 1985.

Then, there is a second area of reserve of $750 million, which we really consider as a separate account, and which may or may not be utilized in the future. Then we have what we might consider as contingent liabilities, which would include subrogated accounts from the receiverships and the number of ICC's that we have outstanding.

Mr. **Barnard**. The point I am saying is, page 6, I am reading, I presume, when you determine that your reserves to total deposits, are you taking all of these elements, including the $8.8 billion, which is the estimated size of the 1-percent deposit of 731, 1985?

Mr. **Stearns**. No, we have not utilized that at all. This is strictly what is in the fund right now, and this includes on a cash flow basis the new premiums and so forth.

Mr. **Barnard**. What is the percentage of reserves to total deposits today?

Mr. **Stearns**. Somewhere around 0.7 percent.

Mr. **Barnard**. 0.7 percent.

Mr. Poling, what is it with the FDIC?

Mr. **Poling**. Somewhere slightly above 1.26 at the present time.

Mr. **Riley**. 1.35.

Mr. **Barnard**. Thank you, Mr. Riley.

My time has expired.

Chairman **St Germain**. We have a very important vote. It has to do with the kidnaped lady, Duarte's daughter—maybe we will get her back with this vote. We will be in recess for 10 minutes.

[Recess.]

Chairman **St Germain**. The subcommittee will come to order.

Mr. Stearns, did you tell the committee that the examiners at Beverly Hills and San Marino were purely, singly, uniquely, and only State examiners?

Mr. **Stearns**. Sir, when we talk about examiners, that just is not my baliwick. I don't know the answer to that.

Chairman **St Germain**. Would you turn around and find out? We have all of this high-priced talent here. Let's use it.

Mr. **Stearns**. We use our own examiners in there, too. What I am not certain of is who has the prime responsibility.

Chairman **St Germain**. It doesn't matter. You stated in your testimony, as I recall it, that one of the problems in those institutions was the fact that—maybe it was Mr. Wolf—there was no differentiation between whether it was an investment or a loan in many of these developments.

Mr. **Stearns**. He said that. I said the problem we have was the lag time in such a fast-growing institution.

Chairman **St Germain**. You testified very briefly, Mr. Stearns. That doesn't mean we will not ask you questions. Is Mr. Wolf erroneous when he makes that statement?

Mr. **Stearns**. No, sir.

Chairman **St Germain**. Go back again, I asked you earlier, if it was difficult to tell the difference between an investment and a loan for an examiner. Is it, or is it not?

Mr. **Stearns**. I think in some cases, the answer is yes, sometimes there is a difficulty in determining the difference between a loan and an investment.

Chairman **St Germain**. Is there a difficulty in determining whether it is a loan or an investment?

Mr. **Stearns**. Yes, sir, in some cases there are. We have tried to define that.

Chairman **St Germain**. My question is, is it sometimes difficult to differentiate, and you say yes, it is. And is it also difficult to determine whether a differentiation has to be made?

Mr. **Stearns**. Yes, sir, I think that is true, too.

Chairman **St Germain**. Mr. Wolf, do you agree with those two answers?

Mr. **Wolf**. I think I would agree with the first one, that sometimes it is tough to tell.

Chairman **St Germain**. My second question is, is it difficult for an examiner to determine whether it is an investment or a loan?

Mr. **Wolf**. That is not very difficult most of the time.

Chairman **St Germain**. Mr. Stearns, I tend to agree with Mr. Wolf. If you have a good examiner, he should be able to recognize that there is a problem in determining whether it is an investment or a loan.

Mr. **Stearns**. He said most of the time, and I agree with him.

Chairman **St Germain**. Again, were there Federal examiners in San Marino and Beverly Hills along with, or in separate instances in California, the State examiners?

Mr. **Stearns**. Yes, sir, I believe there were.

Chairman **St Germain**. We can't blame it all on the fact that the State examiners didn't recognize the potential problems. There is some responsibility that lies with the Federal examiners, isn't there?

Mr. **Stearns**. Yes, sir.

Chairman **St Germain**. We may want to pursue this a little further. Who is in charge of the examination process at the Federal Home Loan Bank Board? Is it the California Home Loan Bank?

Mr. **Stearns**. No, sir, our OES Division.

Chairman **St Germain**. Aren't you transferring those functions to the Federal Home Loan Banks?

Mr. **Stearns**. The examiners have been transferred out there. We still have responsibility in Washington, of course.

Chairman **St Germain**. OK, identify the people—to whomever might have these answers. We might like to have a little conversation here in the hearing room, that would be nice.

Mr. **Stearns**. Yes, sir.

Chairman **St Germain**. Mr. Bereuter?

Mr. **Bereuter**. Thank you, Mr. Chairman.

Mr. Stearns, you mentioned that there are 14 management consignment programs whose purpose is to rehabilitate failing thrift institutions after they passed into receivership. I have constituents involved in some of those programs.

What has been your success at this point, and the level of financial support during that transition period? Would you help me with a few more details, please?

Mr. **Stearns**. The management consignment program was placed in effect a few months ago, and we feel it has been extremely successful, primarily because, A, it has enabled us to put new management in; B, it has stabilized the situations, which in most cases were very unstable; C, it has given us an opportunity to dig into the problems that the particular institutions have, which in some cases are very difficult to unravel.

As you know, it is a voluntary industry assistance program. We are receiving reports back from some of the initial ones. Our feeling at the Bank Board is, it has been extremely valuable for us.

Our hope is that we can either resurrect these institutions, or eventually sell them, and the management teams that are being provided by the other healthy institutions have been very top quality people.

I mean, we are talking about in some cases the chief executive officers, the No. 2 man perhaps in a number of cases.

You have to realize with real estate problems, in a number of these cases, when we have walked in in the past, we have taken many, many months to try to unravel what is there.

The management consignment programs have helped us considerably in that area.

Mr. **Bereuter**. Page 4, you make reference to cash deposits. Under what circumstances does the Board require cash deposits with the FSLIC?

Mr. **Stearns**. The deposit requirement? That is a tool that we have to fall back on, if we would wish to do it. We have not asked for deposits.

Mr. **Bereuter**. I see.

Mr. Poling, you indicate that the FDIC is devoting resources to contingency planning for individual banks or groups of institutions. Without naming banks or going into specifics, can you tell me a little bit more about this aspect of your organization's planning efforts, your efforts to do contingency planning?

And when did you start it, for example, in an organized and concerted fashion?

Mr. **Poling**. We devote an exceptional amount of resources to the planning of future bank failures. In terms of the contingency planning for a large bank failure, it came to the forefront after the Continental transaction.

Mr. **Bereuter**. What you are now doing has enabled you to step in after Penn Square and avert Continental Illinois?

Mr. **Poling**. It would not have. We have had on the shelf plans for the last 5 years temporary interim type steps, but we have really dissected the Continental transaction to put it into a volume where we have been very frank in what mistakes we made, what we did right.

We are trying to prepare documents to—if we ever have a situation like that again.

Mr. **Bereuter**. You are saying for this category, a very large bank, for a bank with these characteristics, this is the kind of contingency planning that we should conduct, and that you prepare such contingency plans?

Mr. **Poling**. It is probably unreasonable to do it for individual banks because you have to tailor the type of response to that bank.

Mr. **Bereuter**. How many resources are you devoting to this effort at this time? How many man-years of personnel are involved?

Mr. **Poling**. I would have to estimate simply on the Continental, we have literally spent 15,000 to 20,000 man-hours.

Mr. **Bereuter**. Thank you, Mr. Chairman.

Chairman **St Germain**. How many examiners or personnel are involved, and have been involved at Continental? How many people in numbers?

Mr. **Poling**. It has centered on our liquidation side, not our examination side.

Chairman **St Germain**. Right. Liquidation side. I thought that was a going institution. I didn't know we had liquidated it.

Mr. **Poling**. Yes, it was being liquidated.

Chairman **St Germain**. Those are the ones you are liquidating? But you are not liquidating, because you say in your report that it is not worth trying to estimate losses. So what are liquidators doing there?

Mr. **Poling**. We didn't say that in the report, Mr. Chairman. We literally put out that portion of loans will be analyzed and looked at over the years.

Chairman **St Germain**. Therefore, you anticipate losses. So, GAO isn't all that wrong; are they?

Mr. Poling. Only in the sense where we should have had the ability to analyze that amount of loss in the portfolio. We totally disagree with that, and if one looks at the transaction and realizes what happened and the timing, a reasonable person would conclude that.

We were getting $2.1 billion of loans transferred to us at the end of September from all over the world. It was our first look at those.

Chairman St Germain. Why were they transferred to you, rather than being kept at the new Continental? Questionable, aren't they?

Mr. Poling. Of course, we state that, surely.

Chairman St Germain. OK.

Mr. Cooper?

Mr. Cooper. Thank you, Mr. Chairman.

I apologize for getting here late. I don't have any questions right now. I look forward to reading the testimony of the witnesses.

Chairman St Germain. Mr. Wortley.

Mr. Wortley. Thank you, Mr. Chairman.

Mr. Stearns, on page 16, you state that the cash flow management is being improved, correlated more closely with investment policy. Would you elaborate on that? What kind of steps are you taking?

Mr. Stearns. We constantly have under review investment policy, and work closely with the Office of Finance. We have meetings every month to review investment policy, based on what our projections might be for use of cash.

These change constantly, and we have our own committees internally, as well as using the Office of Finance, which actually undertakes management, if there are changes in the portfolio, but this is a constant status that goes to the Federal Home Loan Board for review.

We do that at least once a month, sir.

Mr. Wortley. Things are changing that fast?

Mr. Stearns. Yes. We are constantly changing the maturities and based on forecasts, changing the requirements for cash as opposed to investments, and so forth.

It is a large amount of money, and it depends on whether we have receivership income coming in.

Mr. Wortley. Page 14, you say that normally, the FSLIC does not become involved in guaranteed bank advances. Yet, you note that, on August 31, 1985, FSLIC was the guarantor of approximately $2.5 billion of bank advances with commitments to guarantee another $2 billion, if it is needed.

This figure seems rather substantial for something that FSLIC does not normally get into. Will FSLIC continue to get involved to that extent? What are the risks involved? Has it cost you anything up to date?

Mr. Stearns. With the exception of one small case, it has never cost us any money, and in most cases——

Mr. Wortley. Still a risky business?

Mr. Stearns. Very, very minimal. There are $80 billion of advances out there, we are guaranteeing a small percentage of those with institutions that we have normally taken over. There is normally collateral taken over to back up these advances.

And we find it to be riskless. We look pretty closely, but there has only been one instance where these advances have cost us any money.

Mr. **Wortley**. It sounds like a substantial sum.

Mr. **Stearns**. We have a substantial number of cases. As the caseload increases and each case gets larger in size, this number is probably going to grow, but it has not been a cost to FSLIC at this time.

Mr. **Wortley**. Mr. Riley, I don't have a question for you, but did you stay here overnight?

Mr. **Riley**. I feel like it.

Mr. **Wortley**. Mr. Poling, the FDIC has provided this subcommittee with data showing that in 1984, 79 banks failed. Your testimony suggests that the upward trend of bank failures has not yet peaked, and that you expect at least 100 this year—100 next year, excuse me.

What kind of financial and economic background conditions are being assumed for you to reach this estimate? What do you see happening out there that will cause another 100 next year?

Mr. **Poling**. Our predictions are based on the level of turnover on our problem list.

Mr. **Wortley**. I would hope that you would be doing some things in the interim so next year, we wouldn't have 100.

Mr. **Poling**. A good part of the Corporation's efforts are being utilized on the supervisory side to change those problems, and I think we have also provided data to the subcommittee which showed the improvements from the problem list.

In other words, that list is constantly rolling over and changing, and it is not simply a bank failure that happens to take it off the list.

I believe last year, 220 banks, roughly, were taken off the problem list, through supervision type efforts.

Mr. **Wortley**. 220 came off of the list last year?

Mr. **Poling**. Yes, sir.

Mr. **Wortley**. That is good supervision. My time has expired. Thank you, Mr. Chairman.

Chairman **St Germain**. Mr. Poling, would you be considered the No. 1 man at the FDIC Insurance Fund?

Mr. **Poling**. My position is essentially the Comptroller of the Corporation.

Chairman **St Germain**. Do you know what the financial conditions of the Corporation are?

Mr. **Poling**. I believe so; yes.

Chairman **St Germain**. I am not disputing that.

Mr. Stearns, would you be in the same position as Mr. Poling?

Mr. **Stearns**. Not really, sir. My chief financial officer would be more able to speak to the fund numbers.

Chairman **St Germain**. You are the other top honcho?

Mr. **Stearns**. It is my responsibility, but he is the numbers person.

Chairman **St Germain**. The buck stops someplace. Are you the one it stops with?

Mr. **Stearns**. Well, it stops with the Chairman of the Federal Home Loan Bank Board, really. The Board is authorized to run the Fund, and they do.

Chairman **St Germain**. Right, but by the same token, you are there for the everyday operation, and the Chairman and the Board have many other duties as well?

Mr. **Stearns**. Yes, sir.

Chairman **St Germain**. Mr. Riley, as to your insurance fund, where are you in the hierarchy?

Mr. **Riley**. I run the insurance fund.

Chairman **St Germain**. Mr. Barnard asked me a question, and now I am at a loss to answer it, so I am going to direct to you, gentlemen.

He asked me why we are having these hearings, because according to what you gentlemen are saying, the funds are in great shape. We don't need anything. If they are in such great shape, what are we having hearings for?

Mr. Poling, Bill Isaac often sends us papers, and I had one on my desk this morning where he says the big problem that must be addressed is the insuring fund.

Either they need help or they don't, right, Mr. Poling? You come up here and tell us that the insuring funds are in perfect condition, then—and if you stand by that, maybe I will cancel the rest of these hearings.

Mr. **Poling**. I don't think we have made any attempt to say the insurance funds are in perfect condition. From the financial statement, we are absorbing tremendous losses, over the past 5 years, and the problem, sir, it is at all-time historic highs.

We are saying we see a continuation of problems that we have been experiencing, over the immediate future, I wouldn't even predict what period of time.

We have said we have certain things that we believe can be done by the Congress to improve the Federal Deposit Insurance Systems. We have time after time come up here and explained what we see is a very real threat from brokered deposits.

We have tried to document and evidence that claim. We have any number of legislative proposals up here to improve the system by such things as risk-related premiums, things of that nature.

We are not in any sense of the imagination saying things are perfect. We are saying Congress can help us in improving them.

Chairman **St Germain**. How soon do you need the help?

Mr. **Poling**. In terms of the brokered deposits issue, I would say immediately. In terms of the expiration of the Garn-St Germain bill, I would say within the next month.

Chairman **St Germain**. Keep going.

Mr. **Poling**. I don't know how I could set priorities on the other issues, but——

Chairman **St Germain**. I thought you were going to say yesterday.

Mr. **Poling**. I wouldn't be that presumptuous.

Chairman **St Germain**. We ask. We don't always agree, but we ask. Mr. Stearns?

Mr. **Stearns**. Well, sir, as you know, the policy decisions are generally referred to the Chairman, but I would agree that our fund certainly is not in a good position. We are looking at losses. We looked at a major loss last year, and losses again this year. Our cases are not getting any easier.

We are constantly developing methods to both defer and to handle these problems, some of which you are aware of in the testimony.

We think we have a manageable situation, but it is not particularly comfortable, and we need assistance from the Congress also. And I am sure that the Chairman is going to be addressing that in the next couple of weeks, but we are scrambling. And we are perpetually changing our approach to how we resolve our cases, when we resolve them, and under what basis we can do it.

Chairman St Germain. Using ingenuity and innovation?

Mr. Stearns. We are trying.

Chairman St Germain. Gentlemen, let's face it, the Chairman is going to be called upon to move legislation. I have to be able to demonstrate that there is a need for the legislation. That is why this question is of utmost importance.

Mr. Riley, according to you, you are in fantastic shape. Remember, these words are inscribed in the hearing record. Don't come running to us 6 months from now and say all of a sudden that you have a great big problem.

I hope you haven't hidden anything away in the forest that might come creeping out some evening, afternoon or morning.

Mr. Riley. I do, too. We still consider the National Credit Union Shared Insurance Fund in very good shape based on actions Congress took last year. We are only asking for the extension of the conservatorship authority, and we hope to continue the progress we made during the last year.

Chairman St Germain. Mr. Wylie.

Mr. Wylie. Thank you, very much. What you gentlemen are saying, Mr. Poling and Mr. Stearns, the funds are manageable now, solvent for the moment. But they won't be in the future, and you have not identified how far in the immediate future that might be if the cash-flow continues as it has been in the past few years.

Is that an accurate assessment of the bottom line?

Mr. Poling. Clearly the FDIC feels very confident of our financial resources to handle any foreseeable type contingency. Although we see, again, repeating those issues——

Mr. Wylie. But the amount of the fund has been reduced in the past couple of years.

Mr. Poling. No, our fund has not. Our fund is growing.

Mr. Wylie. How about yours, Mr. Stearns?

Mr. Stearns. Our fund is not increasing. It has shown losses, and if we can keep the losses at the same basis as the past 2 years, we are all right on a deferral basis. But we have a number of cases out there, and if they all came down at the same time, we would have problems. We don't foresee that.

We also have a very strong confidence in the bank system to back us up. Those resources we have never used. We are scrambling to keep this thing going, but we need help.

Mr. Wylie. Let me say that, I know you are not the policy makers. You have said that, and have identified others who are, but you do administer the funds and have some expertise in this area, so your judgment and opinion is important.

The bankers in my district and savings and loan people indicate to me that they think we need to come up with some sort of a risk-related program called insurance, and that is what it is, insurance against a contingency where there might be a problem.

Do you have an opinion, Mr. Poling, on risk-related insurance?

Mr. **POLING.** Yes, I professionally support and believe in risk-related premiums. I think the impact will be nominal, but very important in terms of trends and pointing out that the industry, the problem side should be absorbing more of the cost of the insurance fund. It makes common sense.

Mr. **WYLIE.** One of the problems I have when we talk about it, if you identify an institution as having a big risk, doesn't that jeopardize their chance to do business?

In other words, this institution is strong, and therefore, the risk is not as great. This institution has a great risk.

Mr. **POLING.** Well, I think the——

Mr. **WYLIE.** How would you go about determining risk? That is my question.

Mr. **POLING.** We are going through a painful experience in trying to come up with the appropriate formats for identifying risk?

I think Chairman Isaac will have a program when he is called before the subcommittee, but we have changed our thinking in the way we originally outlined the three-pronged approach to risk-related premiums. The frank answer to your first question is that the sooner a problem is identified, and the sooner we can address it, the better we are off.

Mr. **WYLIE.** OK, Mr. Stearns, do you have a more specific answer to my question?

Mr. **STEARNS.** Well, we have a very active program taking a look at risk-related premiums and doing it based on the theory that there would be a higher premium for those activities which are beyond the Federal restrictions. My problem, however, is that the horses are already out of the barn and no matter what we put in today we are facing the institutions that are already sick.

Mr. **WYLIE.** Please address those questions and maybe you can supply some help for the record, if that is going to be the recommendation. I can't let the moment pass, Mr. Stearns, now that you have talked about some of the problems of mentioning the Ohio situation, the Ohio problem as far as the State chartered S&L's are concerned, and I was in on some of this.

In accepting the applications, did you adhere to the letter of your own regulations as far as capital adequacy, net worth, reserve requirements are concerned, or did you have to modify them a little bit in order to admit some of those institutions?

Mr. **STEARNS.** My understanding is that we followed the rules for a new entry into the FSLIC in terms of the required capitalization. That is higher than those for a going concern.

Mr. **WYLIE.** How many privately insured thrifts remain in the country, and how many do you think will be remaining at the end of the year? Do you know off hand?

Mr. **STEARNS.** North Carolina has a substantial system, and there have been a number of applications that have come in to us for that, and there are still some remaining in Pennsylvania, but very few, forgetting Ohio and Maryland for the moment.

Most of the institutions in North Carolina we have already admitted into FSLIC, but there are very few remaining, sir.

Mr. WYLIE. Do you think there should be any remaining?

Mr. STEARNS. Well, that is a difficult question. We have certainly been on record to try to promote Federal insurance, but that is a difficult question. However, there are really so few remaining now, that I think that the question may not have the same meaning.

Mr. WYLIE. The Ohio institutions and all of the Maryland ones, but one or two have been able to qualify for Federal insurance, and that did, of course, relieve the situation in Ohio. Without it, we would have been in serious trouble. What do you anticipate as far as the private insurance systems in the United States are concerned?

Mr. STEARNS. I really don't have a comment on it, sir. I don't think that—at this point I haven't heard any discussions about it recently.

Mr. WYLIE. Thank you very much.

Chairman ST GERMAIN. Mr. McKinney.

Mr. MCKINNEY. Thank you, Mr. Chairman.

Mr. Riley, I feel very badly that the lean, mean "no frill" machine you operate is not getting any questions asked, so I thought I would let these guys cool for a while and ask you two questions.

Do you have any idea or analysis of what Treasury II's taxation principal for credit unions would do to their net worth assets?

Mr. RILEY. The agency has no official policy on Treasury II. In my personal opinion, the effect of taxation on credit unions would be on their safety and soundness. Income in a credit union now, that is not going to be paid in dividend, will go to the reserves. I think realistically, the nature of credit unions would change from making their economic decisions, based on consumer considerations to the tax-related impact of the issue.

Mr. MCKINNEY. I am delighted you said that. I could not survive without the Wright-Patman Credit Union.

You seem relatively happy at the NCUA with the law. Do you have any legislative changes that you would propose at all?

Mr. RILEY. We are asking for no new legislation. On October 15, our conservatorship authority expires, and we would like to see that extended.

Mr. MCKINNEY. Mr. Wolf, I happen to think you work for the best organization in Government. I have some of GAO's people working with me in another nonrelated area, the educational system of the District of Columbia, and I have never seen such hard working people.

Chairman ST GERMAIN. Other than the House of Representatives.

Mr. MCKINNEY. I don't dare say that. Actually, Mr. Chairman, they worked almost as hard as we do. This team worked for 6 weeks and only took 2 days off.

We have a problem, gentlemen, and Mr. Wolf has it in reviewing what you are doing. You have it at FSLIC, and FDIC, and I was quoted on the front page of the American Banker, "The obscene stupidity of Federal money insuring banks whose State legislatures have gone increasingly insane, but * * *."

Chairman **St Germain**. Mr. McKinney, your grandchildren may well be reading the record.

Mr. **McKinney**. They will admire my spunk.

Chairman **St Germain**. Some of that language, it doesn't even belong in a Mother Goose Rhyme.

Mr. **McKinney**. The Wall Street Journal described me as the irascible Mr. McKinney, so I have to retain my image.

I was really amazed at the growth figures for the FSLIC and the FDIC and that is one of the reasons I have been watching, something I do instead of playing tennis.

Isn't there some kind of a warning system that you can set up where a bank has to report a growth in assets which is just extraordinary, or too big an amount? Shouldn't there have been some kind of an alarm either at the FDIC or Penn Square? Actually it should have rung at Continental. How about that?

Our problem is an asset growth problem in many cases.

Mr. **Stearns**. We have implemented some new regulations on the side of trying to monitor the growth, and that has become very effective. The growth in deposits in the industry is down recently instead of the significant growth we were watching before. And there are penalties involved. It is the lag time that has always created the problems for us.

Mr. **McKinney**. A thrift institution like San Marino makes Ponzi look like a piker. You may not know who Ponzi was, but I suggest you read "The Great Depression."

I was appalled when you told me how few examiners California has. Our problem—my taxpayers' problem, is the asset quality; that is this massive growth. We have got to put in some kind of regulation where banks would have to inform you of any unusual asset growth. I would like to hear any suggestions you may have, and I hope that you or Mr. Gray will write me.

The problem is the bigger the institutions get, the less percentages mean in growth. Because as my good friend, Felix Rohatan, would say, "If it is so damn good, how come it pays so much?" That is what has happened to us.

Mr. Poling?

Mr. **Poling**. Mr. McKinney, you are right. It is probably the No. 1-factor that tips off to problems, probably outside of the banking industry, too. Banks submit call reports quarterly, and growth is one of our primary tests in an off site monitoring systems we use.

Mr. **McKinney**. In this day and age of greed, perhaps we could monitor banks every month, every 30 days. If you look at San Marino, from 1979 to 1984, it's assets increased 200 to 400 and some odd million. I mean, my God, in 90 days, and the last 11 months of Penn Square, quarterly report, the next quarter, they are already sunk. The hole is so deep you can't find the bottom of it.

These guys don't stand around on minor circumstances. They throw it around. They make four phone calls, and they suddenly come up with a half a million dollars worth of brokered deposits, bango. Don't you think we ought to regulate this a little better?

Our friends in Boston also managed to launder a billion dollars in a very short period of time.

Mr. **Poling**. Once the problem is identified, you can address it with monthly reports, if that is the case.

Mr. **McKinney**. Internal coordination concerns me. Has something been done about the situation that happened when Penn Square failed? When Penn Square failed, I asked two questions. Why was Sea First in so heavy, and why was Continental Illinois? I was informed by the Comptroller's Office, the gentleman is not here today, that Seattle First was not a very well-run bank.

I was informed it was an aberration, and we are going to suffer from that for a long time. Have you done anything regulatory-wise, because the regulators who went into Penn Square, never informed the regulators in Chicago of the fact that Contilly poured $900 million into Penn Square in the last year.

Mr. **Poling**. The lines of communication and cooperation improved greatly over the last couple of years, and they improve after every disaster even more.

Mr. **McKinney**. We can't afford a heck of a lot more disasters, Mr. Chairman.

Chairman **St Germain**. Gentlemen, as to the lines of communication, they are not all that great yet. One of my questions will emphasize that later. Let's not get too happy about that. They have improved, but there is still room for more improvement.

Mr. **Wylie**. Could I ask Mr. Wolf a question?

Chairman **St Germain**. Well, we have a vote.

Why don't we come back? We will be in recess for 10 minutes, and then we shall return.

[Recess.]

Chairman **St Germain**. Mr. Wylie, you said you had a question for Mr. Wolf.

Mr. **Wylie**. Yes, I did, Mr. Chairman.

On page 2 of your testimony you said you won't discuss the adequacy of the deposit funds, or were not asked to discuss that.

Do you have an opinion as to the adequacy of the insurance funds?

Mr. **Wolf**. No; we have not tried to do a review to determine the adequacy of the funds. As I said, the one that concerns us more is FSLIC, because of the new problems which have come up of bad loans and the investments by some of them. A specific opinion as to the adequacy, no.

Mr. **Wylie**. I agree with Mr. McKinney, that you do a very fine job in a most objective way.

Is this within the area of your expertise, or are you more in the accounting business?

Mr. **Wolf**. My area is more in the financial and accounting business than the programatic evaluation of the balance itself.

Mr. **Wylie**. OK, thank you, Mr. Chairman.

Chairman **St Germain**. Mr. Barnard?

Mr. **Barnard**. Thank you, Mr. Chairman.

Mr. Stearns, I would like to share with you page 12 of the testimony of Mr. Hemel yesterday with reference to the question 5(e). What proportion of the problem institutions are those with asset quality problems only?

The answer was, the number of institutions with asset problems is 389 or 59 percent of the problem cases. The remaining cases are divided between institutions with spread problems, 32 percent and/or problems, 9 percent. All of this information may be more easily seen in the following table.

In that table, it says that the asset quality problem cases under deposits is asset only, $67 billion. Asset spread is $52 billion or a total of $191 billion, 87358. All right, with the abatement in inflation, with real estate values being what they are today; and most of these investments being in real estate, I would presume hopefully, of the $191 billion, 873 deposits, how much in losses would you feel would be there?

Mr. **STEARNS**. Well, I think the standard procedure we have been using in asset-based cases is we look at generally a loss of around 15 percent as an average number.

Mr. **BARNARD**. More than I thought. I thought 10 percent. You are talking about then 100. I mean you are talking, then, somewhere between $15 and $20 billion.

Mr. **STEARNS**. I think—let me give——

Mr. **BARNARD**. No, no. I am having a little trouble with my own thoughts. Don't add nothing to it.

Mr. **STEARNS**. On the asset-based cases, we look at 15 percent. On the interest spread cases, we are looking at losses of 5 percent, and that averages out to a lower number.

Mr. **BARNARD**. You are talking about $9 billion in asset only, and $2½ billion, then, with asset spread, so you are talking about then adding that together. You are talking about approximately $12 billion.

Mr. **STEARNS**. Over a period of time, yes.

Mr. **BARNARD**. OK, what is the answer? Certainly the FSLIC's reserves are not adequate to anticipate that today; are they?

Mr. **STEARNS**. You must remember that the numbers we are using here are not failed institutions, but they are potentially failing institutions.

Mr. **BARNARD**. True, but on the other hand, we are only taking a percentage of what we think the losses are, not a 100 percent.

Mr. **STEARNS**. Sir, but a number of these institutions will never become FSLIC cases.

Mr. **BARNARD**. Why?

Mr. **STEARNS**. Because we have developed and are developing a number of capabilities to head off some of these situations before they happen. We will sell a number of them as nonassisted-based solutions, and on the merger side, we are putting in management teams to stabilize and prevent losses.

We are endeavoring to solve a number of cases. You know, there are institutions out there that are——

Mr. **BARNARD**. In other words, you are saying there are no losses here, then. That is all I am trying to find out. Have you any idea, or would you offer us some indication—and I am trying to do this for the FSLIC, not to harass you, but to find out how much more we have got to increase the reserves of the FSLIC.

Mr. **STEARNS**. It is fair to look at the fact that FSLIC is looking to lose money in the next couple of years based on any kind of projections put forth and based on the fact that we are adding substantially to our income through the increased premiums. We are trying to manage those loses under a specific basic number, and defer the rest of the losses in some other manner.

If we are able to do that, the reserves will come down, but the fund will exist in a reasonable manner. If we are unable to do that, we are then going to have to use a different alternative, utilize the banking system, or request the deposits from the member institutions, which we are capable of doing.

At this point, we are hoping that we can manage these problems, and that they will not come in all at once, and that hopefully, through our management techniques, we can lower those losses that we have been looking at, in other words, reduce the 15-percent number.

Mr. **Barnard.** Are you aware of the liquidation corporation that we are talking about setting up?

Mr. **Stearns.** I hope we will be able to reduce those losses by managing those assets ourselves, instead of having to contract them out.

Mr. **Barnard.** Page, FSLIC sources of funds summary, it interests me, though, that the largest amount of resources that you have there is the $8 billion which is the estimated size of 1-percent deposits as of July 31, 1985.

Is that the so-called 1-percent set-aside?

Mr. **Stearns.** Yes, sir.

Mr. **Barnard.** You already have that authority and power to impose that 1-percent aside?

Mr. **Stearns.** Yes, sir, we do.

Mr. **Barnard.** Has there been a decision up to now?

Mr. **Stearns.** No; there are two plans out there. One is a recapitalization which would put the same amount of money in and provide us more flexibility to use these funds. And the other is the ability to use the 1 percent which we can't do now.

Mr. **Barnard.** What would determine, or what conditions would exist then?

You are now 0.7 percent of reserves. How bad would the reserves have to get before you would implement this 1 percent?

Mr. **Stearns.** I think that is a bank board decision; and I am not sure that this would be our next step.

Those funds, based on the way they are now, without a change in legislation, would have to pay a going rate of interest. We have looked at the fact that it would not—although it would add liquidity to the fund, it won't add much in the way of income.

If we recapitalize, call the funds in on a different basis, and were able to use those funds for solutions, it would make a big difference.

Mr. **Barnard.** Has the FSLIC ever made a presentation to Congress or testified what that new capitalization plan is, and how would you put it into effect?

Mr. **Stearns.** No, sir, we have not, and it really hasn't been discussed with the trade associations, but it may be something that we have come to you with to put into effect.

Mr. **Barnard.** Mr. Chairman, I would like to ask for unanimous consent that we at least be brought up to date as to what the plan is; and at least we would be advised, because this is a very important aspect of, I feel, of the future enhancement of the FSLIC funds.

Chairman **St Germain**. I don't see that that should be any problem.

Mr. **Stearns**. Yes, sir; it is a U.S. League proposal to do it, or it was a league plan originally. It was discussed at great length before we went ahead with the increased premium, which the bank board decided was much more logical at that time because it brought immediate funds into FSLIC. We are talking a billion-dollar increase, which has been very, very valuable.

Chairman **St Germain**. Would there be any problem submitting a memorandum for the record that describes that what you are doing, with a copy to the gentleman from Georgia?

Mr. **Stearns**. No, sir.

Chairman **St Germain**. Without objection, it will be placed in the record when received immediately following this period of questioning by Mr. Barnard.

[At the time the hearing went to press, no information was received by Congressman Barnard.]

Chairman **St Germain**. Is that it, Mr. Barnard?

Mr. **Barnard**. My time has expired.

Chairman **St Germain**. Let's get back to those liquidators at Continental.

How many do you have there?

Mr. **Poling**. On the workout staff at Continental, itself, I believe the numbers are somewhere around 160.

We have supervisors and people from our liquidation office out of Chicago, probably another 30 or 40; plus accountants, 20.

Chairman **St Germain**. 160, 30, or 40, would be 190 or 200.

Mr. **Poling**. 225 Maybe.

Chairman **St Germain**. When I asked yesterday for the number of examiners at FDIC, what number was I given?

Mr. **Poling**. Somewhere around 2,220, I believe.

Chairman **St Germain**. Presently?

Mr. **Poling**. Division of bank supervision, open banks supervision, total employees of the corporation, probably approaching 6,000, with maybe 3,000 active liquidators of banks.

Chairman **St Germain**. Three thousand are working on liquidations?

Mr. **Poling**. Yes.

Chairman **St Germain**. There are 2,200 examiners; and those are the 2 categories?

Mr. **Poling**. Yes, sir.

Chairman **St Germain**. We now have 220 presently in one institution?

Mr. **Poling**. Yes.

Chairman **St Germain**. Isn't that a pretty high percentage?

Mr. **Poling**. Yes.

Chairman **St Germain**. FDIC's staff is being worked to the bone at this point in time?

Mr. **Poling**. They are.

Chairman **St Germain**. Because we had testimony not too long ago, your testimony in fact, where you seemed very confident when you talked about the FDIC's resources that enabled them to, "without strain", as you said, weather the adverse impact of closed banking activity over the past 5 years, w-e-a-t-h-e-r——

Mr. **Barnard**. How do you spell that, Mr. Chairman?

Chairman **St Germain**. Are you southerners having trouble with my spelling?

We had a passionate recitation in this committee a few weeks ago, impassioned, tears in the eyes of the witnesses from the FDIC telling us of the hours, and I don't dispute this, that were being put in for this little, tiny institution in New York City; that is, Golden Pacific.

Are you familiar with that institution?

Mr. **Poling**. Yes, sir.

Chairman **St Germain**. We had a very interesting hearing, and I know, you say that, without strain, you are handling all of this.

I am wondering what will happen on Golden Pacific. I wrote a letter on August 8. I guess it could have been interpreted as one that didn't need a reply, but I was trying to encourage the FDIC to make a decision. There is a law that says justice delayed is justice denied. Well, money delayed is money not available.

I think one of the answers I received was because a suit was filed that a decision couldn't be made by the FDIC as to whether or not FDIC insurance would be made available for the holders of the yellow certificates issued by Golden Pacific.

From the testimony before this committee, really and truly in the opinion of this member, and I think the majority of the members of this subcommittee, I concluded that these people were indeed convinced that they were covered by FDIC insurance, for these yellow certificates.

Now, I do not think that it can be proved that the majority of people who bought these yellow certificates were dealing in drugs or any other illicit activity, on that they were trying to hide their money, which was the earlier implication.

It seems as though the bulk of these people were just hard-working people. One lady and her husband, lost a house they were going to buy, because they had lost the funds they had saved to purchase the home.

There is still uncertainty as to whether or not those funds will be honored.

Could you tell this subcommittee, at this time, what the status is of the yellow certificates from Golden Pacific.

By the way, be careful. I have a letter on my desk from a member of the clergy who is Chinese. We do not want the participants going the wrong way, Mr. Poling.

I just thought I should caution you.

Mr. **Poling**. Unfortunately, I don't think I can add to the testimony that we have given previously.

Chairman **St Germain**. Let me look at your title again. You are Director, Division of Accounting and Corporate Services, Federal Deposit Insurance Corporation.

You told me that you are sort of the Comptroller of the Corporation. You say that they are in pretty good shape. Who makes this decision, Mr. Poling?

Mr. **Poling**. It is a legal issue, Mr. Chairman, and the suit that you mentioned filed by Golden Pacific's holding company, I believe, which has filed a claim that the golden certificate liabilities are not liabilities of the bank, and don't belong to the bank, and I believe that is how the case is being impeded. And the legal division is having a very difficult time in struggling whether each is a liability or an insured liability.

Chairman **St Germain**. So there is no way of telling when something might occur?

Mr. **Poling**. I can——

Chairman **St Germain**. Through you I am restating the question, and expressing the hope that good things will happen in the very near future. We have a vote on.

Why don't we break until 1:30, and then we can return? Does anybody have any problem with that?

Fine. The subcommittee will be in recess until 1:30.

[Whereupon, at 12:35 p.m., the subcommittee recessed, to reconvene at 2:10 pm., the same day.]

AFTERNOON SESSION

Chairman **St Germain**. The subcommittee will come to order. I might say to the panel that unfortunately a string of votes came along without our knowing they were going to occur. We just had to delay starting the hearing this afternoon due to that.

Mr. Riley, on page 3 of your testimony, you state that the problem "Federal and federally insured credit unions is down 21 percent from June 1984."

That is a good omen. We like that. Tell us how it was accomplished, or to what do you attribute this?

Mr. **Riley**. We attribute most of the reduction to the fact that the economy has improved in general and for credit unions. Also about 3 years ago, we went back to an annual examination procedure. We upgraded our computer analysis of credit unions from semiannual data.

I think the combination—the economy in terms of the interest rates and the employment, has improved in the last couple of years, plus the fact that from an agency standpoint, we are much more involved in the supervision of credit unions than we have been in several years.

Chairman **St Germain**. Mr. Poling, the number of bank failures appears to be rising steadily, as we see from the statistics, but they mainly involve smaller institutions. With the present staff, which you gave us the numbers on earlier, do you feel that your examinations of liquidation resources are adequate to handle what you project as the number of failures in the next year or so?

Mr. **Poling**. Yes. I would qualify it to say that personnel problems are very very difficult under the Federal pay system to pay people what they are worth. We have an exceptional strain personnel-wise with the hours we demand and the travel we demand in the field, and our turnover has gone straight up.

Fortunately, we get enough people at the entry level to keep that flow, but it is very difficult in a training sense to keep qualified people.

Chairman **St Germain**. I should mention that there is a lot of training involved here.

Mr. **Poling**. Absolutely.

Chairman **St Germain**. Do you find that the people that leave, for the most part, go to financial institutions?

Mr. **Poling**. That is fairly accurate; yes.

Chairman **St Germain**. The Deputy Comptroller yesterday told us that they are experiencing a new phenomenon, in that they have personnel who leave and go to financial institutions. Then, after a period of time they are disappointed in what they are doing at these financial institutions. It just doesn't live up to their expectations, and soon some return to the fold.

Have you had that happen to you?

Mr. **Poling**. We have had a couple return.

Chairman **St Germain**. But nothing that is significant?

Mr. **Poling**. No.

Chairman **St Germain**. Has the FDLIC prepared contingency plans for the handling of additional small bank failures in the future? If so, would you tell us what these plans are?

Mr. **Poling**. The contingency planning we do generally involves whether we are faced with a large number of small bank failures, at what point would we not be able to handle them. For the number of failures that we have been handling for the last 2 years, our resources are just rolling, and it is not a strain from the planning aspect.

I suppose the subject of your question is what shelf items we have.

Chairman **St Germain**. Exactly.

Mr. **Poling**. If we get to the point where we can't physically handle it, I guess our next step would be simply to put some sort of financial assistance into the closed institutions and try to run them under some sort of conservatorship, stack them up until we could get to them.

Chairman **St Germain**. That is the small banks. Let's now look at the large banks. Since the Continental experience last year, has the FDIC worked on developing plans, should another large institution the size, or somewhat close to the size, of Continental require assistance?

Mr. **Poling**. Yes. We have looked, as I mentioned before, very closely at Continental from an objective standpoint, what we did right, what we did wrong, the type of legal documentation we need, the general approach from a people standpoint, and without being too specific, we have on the shelf plans for large bank failures.

Chairman **St Germain**. That sounds good. We hope it doesn't happen, but in view of your answers to my previous questions on small bank failures, I am a little concerned, because you might put some of those on the shelf until you can get to them with an infusion of capital. However, with another larger institution, you won't do that. You would have to go right in with personnel, as you did in Continental; won't you?

Mr. **Poling**. Generally, resources and personnel go hand in hand.

Chairman **St Germain**. Yes.

Mr. **Poling**. Yes.

Chairman **St Germain**. With Continental, let's not kid each other. We were aware of the phone calls going back and forth, the meetings—in truth confusion. Despite some denial of facts, I was certain of, in hearings before this subcommittee last year, the fact that there was a controversy amongst and between the regulatory agencies as to how it should be handled.

You say that you have plans on the shelf, should another large institution come to the point that Continental came to. Have you developed these in conjunction with the Comptroller's office, and the Federal Reserve? Are you all working together on these plans?

Mr. **Poling**. No. Those contingency plans are within our own agency.

Chairman **St Germain**. Don't you think that the time has come for contingency plans for that type of situation? And that they should be developed in such a manner that there is agreement among the agencies on the validity of the contingency plan?

Mr. **Poling**. Frankly speaking, once a bank fails, it is ours.

Chairman **St Germain**. Really?

Mr. **Poling**. Yes.

Chairman **St Germain**. Could you have taken care of Continental alone, Mr. Poling? It seems to me that the Federal Reserve Board played a part in it.

Mr. **Poling**. They certainly did.

Chairman **St Germain**. Yes; and it seems to me that communication from the Comptrollers' office in many of the failures, prior to Continental and since could be improved substantially with the FDLIC, couldn't they?

Mr. **Poling**. Yes; and it is improving.

Chairman **St Germain**. Communication is a two-way street. You don't feel that you should just operate independently, do you?

Mr. **Poling**. No.

Chairman **St Germain**. Not both talking to the Federal Reserve Board or the Comptroller about these contingency plans for the large banks?

Mr. **Poling**. I didn't infer that, Mr. Chairman.

Chairman **St Germain**. Well, you said once a bank fails, it is ours. I disagree with that, because Continental had failed. It was brought back to life. We are back to the Bible again. It was resurrected. It was dead as a door nail, but you resurrected it.

You didn't do that alone, though, did you?

Mr. **Poling**. No. My point is once a bank comes to the point where contingency planning becomes actual, the other agencies are naturally involved. We simply have not involved the other agency.

Chairman **St Germain**. You don't think it is advisable to?

Mr. **Poling**. We will take it under consideration.

Chairman **St Germain**. Gentlemen, I wish you would, because if you don't, and you have another failure, if another large bank gets in trouble like this, I am going to ask that you be a witness before this committee. And you won't enjoy it.

Mr. Vento?

Mr. **Vento**. Thank you, Mr. Chairman. I guess whenever you change members, you get to focusing on different things, and so I have to shift gears a little bit as I didn't arrive at the hearing early enough this morning to hear all the questions.

I looked over some of the statements of Mr. Poling, and is there a distribution that goes on now back to times when there are earnings on the deposit funds?

Apparently, there is a distribution back to the members. Was there any distribution in 1984?

Mr. POLING. The distribution, I guess you refer to, is on the assessment.

Mr. VENTO. Yes.

Mr. POLING. It was very small in both 1983 and 1984.

Mr. VENTO. I didn't notice that set out in here very clearly. Is there any reason for that? Did I miss that? What was the distribution?

Mr. POLING. The actual assessment, I believe, in 1984, rather than being the straight one-twelfth of 1 percent of deposits worked out after the net rebate.

Mr. VENTO. Yes, the rebate.

Mr. POLING. Worked out to about one-thirteenth and a half, I believe. We gave an 8 percent, if I am correct, rebate in 1984. In 1983 it was something more than that, perhaps 12 percent.

Mr. VENTO. Twelve percent?

Mr. POLING. Yes.

Mr. VENTO. How many dollars are we talking about in that instance? Is that in here? Am I missing that?

Mr. POLING. It is in our annual report.

Mr. VENTO. It is in your annual report, but not in your testimony.

Mr. POLING. No.

Mr. VENTO. What was the dollar amount of that? I guess you could pick them out. You say it is very small, I am just trying to get some idea of the magnitude.

Mr. POLING. In 1984 $70 million and roughly 100 in——

Mr. VENTO. Why do you insist on doing that when, in fact, we are in trouble? Is this based on the good performance of the institutions? How is that based?

Mr. POLING. It is set by law in the FDI Act.

Mr. VENTO. It is set by law.

Are you seeking the repeal of that in your amendments?

Mr. POLING. No, sir.

Mr. VENTO. You do not?

Mr. POLING. No.

Mr. VENTO. The FSLIC—I noticed in your testimony that that was not—Mr. Stearns, that there was no distribution; is that accurate? Did I understand your testimony correctly in that vein?

Mr. STEARNS. Yes. I think there is room to return some of the secondary reserves under certain basis. We are a long way from that basis. Other than that, there is nothing.

Mr. VENTO. There has been nothing for some time, is that accurate?

Mr. STEARNS. Yes.

Mr. VENTO. Credit unions, Mr. Riley, they have a return coming again this year, don't they?

Mr. RILEY. Yes. We didn't charge a premium either this year, and we will pay a dividend on the deposit.

Mr. VENTO. And what is the size of that?

Mr. RILEY. The actual dividend hadn't been determinied yet, but it will be around $35 million through this fiscal year.

Mr. VENTO. In looking over the reports, Mr. Stearns, and some of your comments, I think it is a very helpful explanation to members, to policy makers. What I was wondering is, I think it is on—well, no; it is not in the income summary. I have to go back through these pages of material, but on page 9 of your statement, you have the FSLIC asset summary.

What I am wondering is on the net subrogated accounts and on the net ICC's, that is to say the income capital certificate, net worth certificates, do those figures reflect the earnings?

Do those accounts have earnings that are factored into that amount or not?

Mr. STEARNS. No; they don't.

Mr. VENTO. For the 1984 year.

Mr. STEARNS. You are looking at the physical assets summary on page 9. Those are just—there are no earnings related to those. Those are simply subrogated accounts, as you can understand and are from the receiverships.

Mr. VENTO. Yes.

Mr. STEARNS. FSLIC, in fact, does not own the property.

Mr. VENTO. I know that, but you are subrogated. I guess that is what that means.

Mr. STEARNS. Yes.

Mr. VENTO. You have the certificates for which you traded.

Mr. STEARNS. Right.

Mr. VENTO. I guess for the issuance of certificates right.

Mr. STEARNS. That's correct.

Mr. VENTO. The point concerning those accounts is if you were to look at one particular entity in that, it would have a running interest rate on it. It would have an earning if indeed you are able to collect it; is that accurate?

Mr. STEARNS. I don't believe there is an interest rate, but there is a hope that we are going to collect on both of these accounts.

Mr. VENTO. So the longer you have those, it is not necessarily so. You would have to write off a certain amount of them. I guess the initial amount, as I remember reading in previous comments in your prepared testimony, was like $1.7 billion on the net subrogated account.

However, it indicates that you only collect about 1.1, so in other words, the other $600 million represents what you expect to be the loss.

Mr. STEARNS. We estimate an approximate 33 percent loss on those accounts. That is correct.

Mr. VENTO. Yes; the point is, though, what is the timeframe over which this occurs, they are nonliquid assets obviously, but what is the timeframe over which you expect to collect this, or would expect to collect this?

Mr. STEARNS. I think we make a maximum effort to collect as much cash as we can from these accounts while we are managing them. Some of them we are contracting out. We try to combine a utilization of efficiency in getting back the maximum we can as well as liquidating the account—in some cases you are looking 3 or 4 years out before you can finally dispose of some of these assets.

In some cases we end up even managing on a longer term basis if we feel that we have to. That is a very unusual situation, but we have done that.

Mr. **Vento**. You don't manage these accounts, though, on the other hand. You actually employ someone or contract someone to manage those accounts.

Mr. **Stearns**. In some cases we manage them. We only have a very small staff. In some cases we contract, at least in the most recent cases for large failures, we do contract out.

Mr. **Vento**. Is there any market, for instance, where you could sell those and make that asset liquidate?

Mr. **Stearns**. We are constantly in the market selling these assets, and we are constantly holding auctions revitalizing the properties. A whole string of properties we inherited in Dallas, and a number of them have been revitalized and are being rented out at reasonably attractive prices.

We are in the market almost every day with new contracts to sell properties that we have under our account.

Mr. **Vento**. I guess my time has expired.

Chairman **St Germain**. Go ahead.

Mr. **Vento**. The point is, of course, with those that you expect that particular—what is your projection for 1985 for those subrogated accounts?

Mr. **Stearns**. The number, as it stands right now, is $2.2 billion of subrogated accounts with a net number of $1.25 billion.

Mr. **Vento**. So that has grown by about 40 percent?

Mr. **Stearns**. Yes, sir. It is our fastest growing area, without question.

Mr. **Vento**. And it represents a special problem.

Now those particular auctions, those are generally for failed institutions; is that correct?

Mr. **Stearns**. That is correct.

Mr. **Vento**. The other point, in other words, in the negotiation for mergers, often you would take those particular accounts out of the merger; is that correct?

If there is a merger very often part of the agreement is that you would take some of this bad paper?

Mr. **Stearns**. We attempt not to. We attempt to sell almost all of our institutions in one piece if we can.

If the real estate problems are so difficult, occasionally what we will do is take out what we call the bad assets and sell off the good assets or the deposits.

It is a secondary choice for us definitely; but we would attempt in most cases to try to market the institution as a going concern first with the real estate as an asset intact.

Mr. **Vento**. I come from an urban environment, but I do come from Minnesota. One of the concerns that has been expressed repeatedly, and I asked the FDIC about it, and they said no it doesn't happen and so I want both the FDIC and the FSLIC to respond to this. With agriculture debt, where a loan is collateralized by land, and the bank or financial institution fails, and the actual debt, the collateral value, has dropped, land values are down about a third, and even though the loan is current, because the bank has failed, that FDIC will seek to foreclose.

I don't know if FSLIC would seek to foreclose but the specific allegation is that FDIC seeks to foreclose even though the loan is current. Because the collateral of the loan, in other words the land has dropped below the loan value.

How do you manage those particular types of problems where you have a failing institution, and how would it be possible for that to happen, for that to occur?

Mr. Poling?

Mr. POLING. I don't know how to respond to that. I would think foreclosure would be our last recourse, especially if a loan is current. We would carry it, but actively try to sell it to another institution.

Mr. VENTO. Can you make an affirmative statement today that in the FDIC's conduct in managment, that they would not foreclose on a loan that was current, irrespective of the collateral?

Mr. POLING. I could not give you that statement. I simply don't have the facts in front of me.

Mr. VENTO. You understand the problem though?

Mr. POLING. Yes, absolutely.

Mr. VENTO. I mean because if someone is keeping something current, obviously then it gets foreclosed, or that they call the note due, I mean there is discretion within the credit terms to call these due obviously, you get your crop in the field, it is impossible to cash in or bring up that type of money all at once.

Mr. POLING. Certainly.

Mr. VENTO. Do they, in fact, follow a practice where they have what they consider a bad collateralized loan, do, in fact, call due in terms of mangagment of these accounts?

Mr. POLING. As a rule I would suggest no, especially if the credit is current.

Mr. VENTO. You understand they are badly collateralized. I don't want to put words in your mouth here but I think it is a policy that is obviously very frustrating.

Mr. Stearns, would you like to try and respond to that?

Mr. STEARNS. We do not foreclose on current loans, and we basically have a policy that anything that is current and workable we lean over backwards not to foreclose.

Mr. VENTO. Workable, of course, is a question, but if you accelerate collection, if you have a badly collateralized loan because of this land value; would you accelerate the payment? Many times the loan would have terms that permit that.

I guess most loans do if the collateral is disappearing, it gives you the recourse to do so, doesn't it?

Mr. STEARNS. It does, but I think we lean over backwards to try to keep these loans as going loans, and I think the instructions are given out in the receiverships to do that. I am sure there are instances when it doesn't happen, but it is very rare.

Mr. VENTO. I think the thing is I just point to this because we have repeated reports, the custom of the FDIC, and as I said, I represent an almost all urban area, but I am sensitive to this particular issue, and I sincerely hope—but I continue to hear from people that it is happening and that is it. We get the answer back from the FDIC saying, "We are not doing it."

I think we could probably get some specifics and demonstrate it to you if you would like. I just want to go on record here today, because I haven't had the opportunity to have the agencies before this committee for some time, to point out my concern about that.

We have obviously a very difficult decision in these instances with failing institutions, and we don't need that compounded by insuring agencies that are not sensitive to the type of problem here, especially if it is performing. I think you can make a good faith effort to keep these things going rather than to compound the problem.

Thank you, Mr. Chairman.

Chairman ST GERMAIN. Mr. Stearns, in your prepared statement, as well as in your testimony this morning, you itemized eight major sources of the FSLIC's financial strength. Those sources, and the amounts, are listed on page 4 of your prepared statement.

Would you be good enough to briefly explain each of the sources of those funds?

Mr. STEARNS. These are all alternative options for funds. Starting with the top of the line, the primary reserve is the amount of money that we have available to us, basically to pay out. This is the number that we utilize to look at the size of the fund.

The secondary reserve is just that. It is a reserve that came in historically as a result of premiums that the banks paid in or the institutions paid in.

We aren't entirely certain whether we have total use of this particular reserve, but I think that is more of a legal question that I just can't answer right now. It is under discussion at the Federal Home Loan Bank Board as to what are our rights in using the secondary reserve if we have to.

The regular premiums are the one-twelfth of 1-percent premiums that we historically have assessed on the member institutions, and as you are aware, we have in the last three quarters added one-eighth of 1-percent premium—annualized—which we are able to do under our current charter, which amounts to $1 billion a year approximately.

The $560 million number is our investment income, approximately, on an annualized basis, based on current interest rates and results from interest on our Government securities and treasuries and other certificates that we use within the fund.

The 1-percent deposit number of $8 billion, as I explained earlier, we have a call legally to have that amount deposited with us by the member institutions. It has never been done.

We have an open line of credit to the U.S. Treasury of $750 million, which again has never been utilized, and the Federal Home Loan Bank System also has a line of credit open to the U.S. Treasury for $4 billion, which again I believe has never been utilized.

Chairman ST GERMAIN. The NCUA, represented by Mr. Riley, commented in their written testimony about the impact of present movement by credit unions that were otherwise insured by the NCUA share insurance fund. Could both the FSLIC and the FDIC, Mr. Poling, and Mr. Stearns, comment on whether there has been a similar movement from private deposit insurance to their Federal insuring funds? Could you also give us the degree and magnitude of the movement and its impact upon the funds.

I also ask GAO to comment on this impact as well.

Mr. Poling?

Mr. POLING. The movement from private insurance funds to the FDIC's funds has been rather insignificant. We are, however, now receiving a number of applications from the State of Massachusetts savings banks. There are approximately 120 institutions up there of which nearly all have under an application procedure applied for FDIC Insurance.

I simply don't have the facts on the total assets involved. I suspect it is somewhere in the nature of $3 billion.

Chairman ST GERMAIN. Three billion?

Mr. POLING. In total.

Chairman ST GERMAIN. Is that all from Massachusetts?

Mr. POLING. Because the majority of them and the larger ones were already insured by the FDIC.

Chairman ST GERMAIN. How about the co-ops, co-op banks?

Mr. POLING. There is no movement that I know yet to apply to the FDIC.

Chairman ST GERMAIN. Mr. Stearns, other than Massachusetts Mutuals, have you seen no other major movement?

Mr. POLING. Well, I believe in Ohio we had one institution that converted to a State charter and became FDIC insured, but that is basically it.

Chairman ST GERMAIN. So that is $3 billion in assets from those mutuals in Massachusetts that have applied, but that doesn't say they have been accepted yet. Therefore, that is really not significant to the fund.

Mr. POLING. It has no significance.

Chairman ST GERMAIN. Mr. Stearns.

Mr. STEARNS. Well, sir, there have been a number of applications in Ohio and a number of applications in Maryland which I think everybody is familiar with, which we are attempting to——

Chairman ST GERMAIN. To process?

Mr. STEARNS. To process. There have been a significant number in North Carolina, which we are processing very rapidly.

And there have been a few in Pennsylvania, but that is all that is left. I don't know what the Pennsylvania situation is.

Chairman ST GERMAIN. How about Massachusetts?

Mr. STEARNS. There are a great number in Massachusetts. I have been informed that there is a considerable number in Massachusetts that are under our——

Chairman ST GERMAIN. Are they all S&L's?

Mr. STEARNS. They probably aren't. Most of the savings banks up there, I think, are FDIC, cooperative banks, also.

Chairman ST GERMAIN. You have some co-op banks applying as well?

Mr. STEARNS. Yes, but I wasn't aware that we did.

Chairman ST GERMAIN. Mr. Wolf, would you care to comment on my question to Mr. Poling and Mr. Stearns, as to the impact of this shifting on their funds?

Mr. WOLF. I am afraid we can't help you very much on that. Most of that movement, in particular with FSLIC, I think, has occurred since the end of the year, and our audit was as of the end of the year, so we don't have a lot of information.

Chairman **St Germain**. Maybe we will hear from you next year?

Mr. **Wolf**. I think you might.

Chairman **St Germain**. You may have something in the letter that might get into the annual report of the FDIC.

Mr. Riley, like the other insuring agencies, NCUA has a variety of means for assisting problem institutions. You discussed one at the bottom of page 4 of your testimony, wherein you note that "under the capital note program cash is advanced to a credit union in exchange for an interest free subordinate note."

Do you want that to stand? Do you perhaps have a correction, because if that is the case, that is a bonanza; isn't it?

Mr. **Riley**. I would like to correct it just a little bit. That is actually when we put cash into a credit union, when it initially goes in, it is interest free, but as the condition of the credit union improves, we have a sliding interest rate that we do charge on that capital note.

Chairman **St Germain**. Mr. Hubbard.

Mr. **Hubbard**. No questions.

Chairman **St Germain**. Mr. Hubbard has no questions.

Mr. Vento.

Mr. **Vento**. No further questions.

Chairman **St Germain**. I am sure that is very disappointing to the panel. The Chair would like, on behalf of the committee and subcommittee members, to express our appreciation to you. We will have additional questions submitted to you in writing to fill in any of the gaps we may have.

Mr. Stearns, you might be prepared for more questioning about the examinations in California, San Marino, and Beverly Hills.

We will revisit these hearings on Wednesday, September 18, that is Wednesday next, at 10 a.m.

We thank you, and we look forward, I am sure, to seeing you again.

We thank the GAO for their assistance. I would like to also be on record, Mr. Wolf, and if you would convey this to your colleagues at GAO, as thanking you for your assistance, not only in this hearing today, but, as you know, in quite a few areas over the past years. You personally have been very competent, very helpful, and very effective. I am sure that you have problems with GAO too. I hope they are paying you enough.

I hope that things improve both with FSLIC and FDIC, and the wonderful personnel who work with you as well. We appreciate the hard work that they have put in, the long hours they have been experiencing, because of the condition of the industry.

I certainly feel that whatever we can do to assist you in maintaining a level of competent personnel; we should do. I will do my utmost to cooperate and help you out in that area, as I am sure my fellow committee members will.

With that the subcommittee stands adjourned until Wednesday next.

[Whereupon, at 2:45 p.m., the hearing adjourned.]

[The letters of invitation to the witnesses and other pertinent material for inclusion in the record follow:]

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U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

[illegible]

September 3, 1985

Mr. Stanley Poling, Director
Division of Accounting and Corporate Services
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Mr. Poling:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on September 12, 1985, at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the financial resources and condition of the Federal Deposit Insurance Corporation (FDIC). In your prepared statement, please provide specific responses to the following questions:

1. What are the total financial resources now provided for in law and available to assure industry stability and the safety of insured deposits in the institutions under your jurisdiction, including the resources of the FDIC and the Department of the Treasury. Please explain how each of these funding sources could be utilized, and provide a tabulation of the amounts of funding available from each source.

2. What are the major asset, liability, revenue, and expense components of the balance sheet and income statement of the FDIC? In an appendix to your prepared testimony, please include copies of the balance sheets and income statements of the FDIC for each of the past five years.

3. What are the nature and amounts of contingent liabilities of the FDIC arising from assistance extended in previous years? Please provide a tabulation containing a brief description of each type of contingent liability and an estimate of the amounts involved.

4. With regard to the numbers of, and total deposits held by, the "problem institutions" under your jurisdiction, what kinds and amounts of financial obligations do you anticipate the FDIC will have to meet during the next twelve to eighteen months, and what steps are you taking now to be prepared to meet these obligations?

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building twenty-four hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing record, and if delivered when requested, the statement will be made available to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:dDv

[illegible]

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

[illegible]

September 3, 1985

Mr. Peter Stern, Director
Federal Savings and Loan Insurance Corporation
1700 G Street, N.W.
Washington, D.C. 20552

Dear Mr. Stern:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on September 12, 1985, at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the financial resources and condition of the Federal Savings and Loan Insurance Corporation (FSLIC). In your prepared statement, please provide specific responses to the following questions:

1. What are the total financial resources now provided for in law and available to assure industry stability and the safety of insured deposits in the institutions under your jurisdiction, including the resources of the FSLIC, Federal Home Loan Bank System, Department of the Treasury, and governmental corporations the FHLBB could establish under existing law. Please explain how each of these funding sources could be utilized, and provide a tabulation of the amounts of funding available from each source.

2. What are the major asset, liability, revenue, and expense components of the balance sheet and income statement of the FSLIC? In an appendix to your prepared testimony, please include copies of the balance sheets and income statements of the FSLIC for each of the past five years.

3. What are the nature and amounts of contingent liabilities of the FSLIC arising from assistance extended in previous years? Please provide a tabulation containing a brief description of each type of contingent liability and an estimate of the amounts involved.

BEST COPY AVAILABLE

4. With regard to the numbers of, and total deposits held by, the "problem institutions" under your jurisdiction, what kinds and amounts of financial obligations do you anticipate the FSLIC will have to meet during the next twelve to eighteen months, and what steps are you taking now to be prepared to meet these obligations?

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building twenty-four hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing record, and if delivered when requested, the statement will be made available to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:dDw

[illegible]

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

[illegible]

September 3, 1985

Mr. D. Michael Riley, Director
NCUA Office of Programs
National Credit Union Share Insurance Fund
1776 G Street, N.W.
Washington, D.C. 20456

Dear Mr. Riley:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on September 12, 1985, at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the financial resources and condition of the National Credit Union Administration Share Insurance Fund (NCUASIF). In your prepared statement, please provide specific responses to the following questions:

1. What are the total financial resources now provided for in law and available to assure credit union movement stability and the safety of insured shares in the institutions under your jurisdiction, including the resources of the NCUASIF, Central Liquidity Facility, and the Department of the Treasury. Please explain how each of these funding sources could be utilized, and provide a tabulation of the amounts of funding available from each source.

2. What are the major asset, liability, revenue, and expense components of the balance sheet and income statement of the NCUASIF? In an appendix to your prepared testimony, please include copies of the balance sheets and income statements of the NCUASIF for each of the past five years.

3. What are the nature and amounts of contingent liabilities of the NCUASIF arising from assistance extended in previous years? Please provide a tabulation containing a brief description of each type of contingent liability and an estimate of the amounts involved.

4. With regard to the numbers of, and total share accounts held by, the "problem institutions" under your jurisdiction, what kinds and amounts of financial obligations do you anticipate the NCUASIF will have to meet during the next twelve to eighteen months, and what steps are you taking now to be prepared to meet these obligations?

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building twenty-four hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing record, and if delivered when requested, the statement will be made available to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:dDv

[illegible]

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-NINTH CONGRESS
WASHINGTON, DC 20515

[illegible]

September 3, 1985

Mr. Frederick D. Wolf, Director
Accounting and Financial Management Division
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Wolf:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on September 12, 1985, at 10:00 a.m., in Room 2128 of the Rayburn House Office Building. You are specifically requested to explain the methodology, scope, findings, and significance of the GAO's examination of 1984 financial statements for both the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation.

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building twenty-four hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing record, and if delivered when requested, the statement will be made available to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to ten minutes.

Sincerely,

FJStG

Fernand J. St Germain
Chairman

FJStG:dDv

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-114831

August 16, 1985

The Honorable William M. Isaac
Chairman, Federal Deposit Insurance
Corporation

Dear Mr. Isaac:

I was surprised to learn that you did not include our opinion on the Federal Deposit Insurance Corporation's (FDIC's) 1984 financial statements in your annual report. During the course of our audit, we were aware of FDIC's schedule for printing your annual report, and we made sure that our opinion was delivered by the deadline established by your staff.

Government corporations, like private corporations, should include the independent auditor's opinion in their annual reports because of its value to those having financial interests in the corporations. In the case of FDIC, interested parties include commercial banks, the Congress, and the citizenry. I am sure you will agree that our respective responsibilities require both the FDIC and the General Accounting Office to encourage complete, accurate, and timely financial disclosure.

Having an annual financial audit and reporting the results to the public is an important discharge of management's fiduciary and disclosure responsibilities. Including the auditor's opinion on the financial statements in FDIC's annual report provides readers and users with an independent assessment of whether the financial information is complete and reliable. While our report to the Congress includes our opinion and is available to the public, it does not get the same broad exposure as FDIC's annual report. Also, our separate report to the Congress is not a substitute for FDIC's responsibility to the banking community and the public at large.

We have worked with FDIC for many years and have found your organization to be very dedicated and professional. While we have not always been in complete agreement on whether FDIC's transactions are fairly presented in its financial statements, these differences should not be withheld from public disclosure.

The FDIC annual report provides the opportunity for management to comment on our opinion and, thereby, provide its readers with management's perspective. I hope that FDIC will include our opinion in its report in the future.

If you wish, I would be glad to discuss this matter with you further.

Sincerely yours,

Charles A. Bowsher

Comptroller General
of the United States

cc: The Honorable Fernand J. St Germain
Chairman, House Committee on Banking, Finance and Urban Affairs

The Honorable Jake Garn
Chairman, Senate Committee on Banking, Housing and Urban Affairs

The Honorable Jack Brooks
Chairman, House Committee on Government Operations

The Honorable William V. Roth, Jr.
Chairman, Senate Committee on Governmental Affairs

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Examination Of The Federal Deposit Insurance Corporation's Financial Statements For The Years Ended December 31, 1984 And 1983

GAO examined the financial statements of the Federal Deposit Insurance Corporation for the years ended December 31, 1984 and 1983. The examinations were made in accordance with generally accepted government auditing standards.

The Corporation has acquired $2.1 billion of poor quality loans and related assets, as part of financial assistance provided to Continental Illinois National Bank and Trust Company of Chicago, and may acquire an additional $1.4 billion of such troubled loans. The Corporation has not yet estimated the collectibility of these loans and the financial statements disclose no provision for loss. The Corporation acknowledges that collection of the acquired loans is subject to significant uncertainties because of financially troubled borrowers and the effects of general economic conditions on their industries. GAO believes that a significant amount of the loans already acquired will not be collectible. Continental Bank has estimated the Corporation will lose from $551 to $774 million on the acquired loans.

In GAO's opinion, except for the lack of a reserve for losses on the troubled loans acquired from Continental Bank, the financial statements present fairly the financial position of the Corporation as of December 31, 1984 and 1983, the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles.

GAO/AFMD-85-58
MAY 29, 1985

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-114831

To the President of the Senate and the
Speaker of the House of Representatives

This report transmits our opinion on the Federal Deposit Insurance Corporation's financial statements for the years ended December 31, 1984 and 1983. We believe that a significant amount of the $2.1 billion of poor quality loans acquired from Continental Illinois National Bank and Trust Company of Chicago will not be collectible. The 1984 statements should, but do not provide for this loss. Appendix I is our report on the Corporation's system of internal accounting controls, and appendix II is our report on the Corporation's compliance with laws and regulations. The Comptroller General is required to audit the financial transactions of government corporations under 31 U.S.C. 9105, and we conducted our examinations in accordance with generally accepted government auditing standards.

The Federal Deposit Insurance Corporation is an independent agency created by the Banking Act of 1933 to protect deposits in the nation's banks, to help maintain confidence in the banking system, and to promote safe and sound banking practices. The Corporation also is a mixed ownership government corporation under 31 U.S.C. 9102(2)(c).

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, and the Board of Directors of the Federal Deposit Insurance Corporation.

Milton J. Socolar
Acting Comptroller General
of the United States

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-114831

May 3, 1985

To the Board of Directors
Federal Deposit Insurance
Corporation

We have examined the statements of financial position of the Federal Deposit Insurance Corporation as of December 31, 1984 and 1983, and the related statements of income and the deposit insurance fund, and of the changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described further in note 4 to the accompanying financial statements, during 1984 the Corporation acquired $2.1 billion of nonperforming, classified, or otherwise poor quality loans and related assets and it may acquire an additional $1.4 billion more of such troubled loans as part of an assistance program to Continental Illinois National Bank and Trust Company of Chicago. The Corporation has not yet estimated the ultimate collectibility of these loans, and the financial statements have no provision for loss. The Corporation acknowledges that collection of the acquired loan portfolio is subject to significant uncertainties because of financially troubled borrowers and the effects of general economic conditions on their industries. We agree and further believe that a significant amount of the loans already acquired will not be collectible. Continental Bank, as administrator for the Corporation, has estimated the losses on the loans acquired to date by the Corporation will range from $551 to $774 million. Further, the Corporation is committed to provide additional capital or other assistance should it become necessary. The success of the current assistance program with Continental Bank has not been determined, and the financial statements have no provision for any further assistance that may become necessary.

In our opinion, except for the effects on the 1984 financial statements of not establishing an allowance for loss related to the poor quality loans acquired from Continental Bank, as discussed in the preceding paragraph, the financial statements referred to above present fairly the financial position of the Federal Deposit Insurance Corporation as of

December 31, 1984 and 1983, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Milton J. Socolar
Acting Comptroller General
of the United States

Appendixes

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I	Report on Internal Accounting Controls	1
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REPORT ON INTERNAL ACCOUNTING CONTROLS

We have examined the Federal Deposit Insurance Corporation's financial statements for the years ended December 31, 1984 and 1983, and have issued our opinion thereon. As part of our examinations, we made a study and evaluation of the system of internal accounting controls to the extent we considered necessary to evaluate the system as required by generally accepted government auditing standards. This report pertains only to our study and evaluation of internal accounting controls for the year ended December 31, 1984. (Our report on the system of internal accounting control for the year ended December 31, 1983 is presented in GAO/AFMD-84-41, 6/14/84.) For the purpose of this report, we have classified the significant internal accounting controls in the following categories:

--assessments cycle,
--assistance to problem banks cycle,
--expenditures cycle,
--financial reporting cycle,
--investments cycle, and
--payroll cycle.

Our study included all of the control categories listed above. However, we did not evaluate the accounting controls over assistance to problem banks, financial reporting, and investments because it was more efficient to expand our substantive audit tests. The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the Corporation's financial statements. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting controls taken as a whole or on any of the categories of controls identified above.

The Corporation's management is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that (1) assets are safeguarded against loss from unauthorized use or disposition and (2) transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of the inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projections of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation was made for the limited purpose described in the first paragraph and would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of the Corporation taken as a whole or on any of the categories of controls identified in the first paragraph. However, our study and evaluation disclosed no condition that we believed to be a material weakness.

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

We have examined the financial statements of the Federal Deposit Insurance Corporation for the years ended December 31, 1984 and 1983, and have issued our opinion thereon. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures, including tests of compliance with laws and regulations, as we considered necessary in the circumstances. This report pertains only to our review of compliance with laws and regulations for the year ended December 31, 1984. (Our report on compliance with laws and regulations for the year ended December 31, 1983 is presented in GAO/AFMD-84-41, 6/14/84.)

In our opinion, the Corporation complied with the terms and provisions of laws and regulations for the transactions tested that could have materially affected the financial statements.

Nothing came to our attention in connection with our examination that caused us to believe that the Corporation was not in compliance with the terms and provisions of applicable laws and regulations for those transactions not tested.

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENTS OF FINANCIAL POSITION
(In thousands)

	December 31	
	1984	1983
ASSETS:		
CASH	$ 4,158	$ 88,785
INVESTMENT IN U.S. TREASURY OBLIGATIONS (Note 2)	14,436,286	13,992,059
OTHER ASSETS, principally accrued interest receivable on investments	393,944	393,080
CERTIFICATES AND NOTES RECEIVABLE FROM INSURED BANKS (Note 3)	560,883	423,641
ASSETS ACQUIRED IN ASSISTANCE TO AN INSURED BANK (Note 4)	4,457,429	-0-
ASSETS ACQUIRED FROM FAILURES OF INSURED BANKS (Note 5)	2,143,540	1,992,029
PROPERTY AND BUILDINGS (Note 6)	41,701	36,969
TOTAL ASSETS	$22,037,941	$16,926,563

The accompanying summary of significant accounting policies and notes to financial statements are an integral part of these statements.

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENTS OF FINANCIAL POSITION
(In thousands)

	December 31	
	1984	1983
LIABILITIES AND THE DEPOSIT INSURANCE FUND:		
ACCOUNTS PAYABLE, ACCRUED LIABILITIES AND ESCROW FUNDS	$ 100,478	$ 79,581
NET ASSESSMENT INCOME CREDITS DUE TO INSURED BANKS (Note 7):		
Available July 1, 1985	67,548	-0-
Available July 1, 1984	-0-	164,039
LIABILITIES INCURRED IN ASSISTANCE TO INSURED BANKS (Note 8)	3,848,342	-0-
LIABILITIES INCURRED FROM FAILURES OF INSURED BANKS (Note 9)	859,641	1,253,763
TOTAL LIABILITIES	4,876,009	1,497,383
DEPOSIT INSURANCE FUND	17,161,932	15,429,180
TOTAL LIABILITIES AND THE DEPOSIT INSURANCE FUND	$22,037,941	$16,926,563

The accompanying summary of significant accounting policies and notes to financial statements are an integral part of these statements.

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENTS OF INCOME AND THE DEPOSIT INSURANCE FUND
(In thousands)

	For the year ended December 31	
	1984	1983
INCOME:		
Gross assessments earned	$ 1,322,587	$ 1,215,817
Provision for assessment credits	68,548	164,903
Net assessments earned	1,254,039	1,050,914
Interest on U.S. Treasury obligations	1,495,378	1,404,325
Interest on notes receivable	111,730	65,065
Interest on assets in liquidation	168,580	90,462
Other income	2,243	17,161
TOTAL INCOME	3,031,970	2,627,927
EXPENSES AND LOSSES:		
Administrative operating expenses	151,201	135,660
Merger assistance losses and expenses	197,559	127,486
Provision for insurance losses (Notes 3, 5, and 10)	933,374	675,119
Nonrecoverable insurance expenses (Note 11)	17,084	31,426
TOTAL EXPENSES AND LOSSES	1,299,218	969,691
NET INCOME	1,732,752	1,658,236
DEPOSIT INSURANCE FUND - January 1	15,429,180	13,770,944
DEPOSIT INSURANCE FUND - December 31	$17,161,932	$15,429,180

The accompanying summary of significant accounting policies and notes to financial statements are an integral part of these statements.

FEDERAL DEPOSIT INSURANCE CORPORATION
STATEMENTS OF CHANGES IN FINANCIAL POSITION
(In thousands)

	For the year ended December 31 1984	1983
FINANCIAL RESOURCES WERE PROVIDED FROM:		
Operations:		
Net income	$ 1,732,752	$1,658,236
Add (deduct) items not involving cash in the period:		
Amortization of U.S. Treasury obligations	18,104	(59,961)
Loss on sale of U.S. Treasury obligations	982	-0-
Depreciation on buildings	977	897
Income maintenance agreement adjustments	80,753	1,418
Amortization of merger assistance agreements	40,131	51,315
Provision for insurance losses	933,374	675,119
Resources provided from operations	2,807,073	2,327,024
Other resources provided from:		
Maturity and sale of U.S. Treasury obligations	3,755,184	4,346,245
Collections on notes receivable	2,528,119	375,619
Collections on assets acquired from failures of insured banks	1,701,734	611,849
Liabilities incurred in assistance to insured banks	3,848,342	-0-
Liabilities incurred from failures of insured banks	-0-	698,565
Decrease (increase) in cash	84,627	(87,450)
Other decreases (increases)	20,033	(61,013)
TOTAL FINANCIAL RESOURCES PROVIDED	$14,745,112	$8,210,839
FINANCIAL RESOURCES WERE APPLIED TO:		
Purchase of U.S. Treasury obligations	$ 4,218,497	$5,025,978
Acquisition of notes receivable	2,848,342	218,998
Assets acquired in assistance to an insured bank	4,457,429	-0-
Assets acquired from failures of insured banks	2,603,638	2,442,851
Additions to property and buildings	5,709	3,713
Decrease (increase) in net assessment income credits due to insured banks	96,491	(67,858)
Payments on liabilities incurred in failures of insured banks	515,006	587,157
TOTAL FINANCIAL RESOURCES APPLIED	$14,745,112	$8,210,839

The accompanying summary of significant accounting policies and notes to financial statements are an integral part of these statements.

FEDERAL DEPOSIT INSURANCE CORPORATION
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1984 AND 1983

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

General. These statements do not include accountability for assets and liabilities of closed insured banks for which the Corporation acts as receiver or liquidating agent. Periodic and final accountability reports of its activities as receiver or liquidating agent are furnished by the Corporation to courts, supervisory authorities, and others as required.

U.S. Treasury Obligations. Securities are shown at amortized cost which is the purchase price of securities less the amortized premium or plus the accreted discount. Such amortizations and accretions are computed on a daily basis from the date of acquisition to the date of maturity. For the year ended December 31, 1984, the Corporation changed from the straight-line method to the constant-yield method. This change did not have a material effect on net income.

Deposit Insurance Assessments. The Corporation assesses insured banks at the rate of 1/12 of one percent per year on the bank's average deposit liability less certain exclusions and deductions. Assessments are due in advance for each six-month period and credited to income each month. The Depository Institutions Deregulation and Monetary Control Act of 1980 authorized a percentage of net assessment income to be transferred to insured banks each July 1 of the following calendar year to 60 percent. Additionally, the Act authorized the FDIC Board of Directors to make adjustments to this percentage within certain limits in order to maintain the Deposit Insurance Fund between 1.25 and 1.40 percent of estimated insured deposits. If this ratio falls below 1.10 percent, the FDIC is mandated to reduce the percentage of net assessment income distributed to a limit of 50 percent. If this ratio exceeds 1.40 percent, the FDIC is mandated to increase the percentage of net assessment income distributed by such an amount as it determines will result in maintaining that ratio at not more than 1.40 percent.

Allowance for Losses. The Corporation establishes an estimated allowance for loss at the time a bank fails. These allowances are reviewed every six months and adjusted as required, based on financial developments which occur during each six-month period. The Corporation does not state its estimated contingent liability for unknown future bank closings because such estimates are impossible to make. The Corporation's contingent liability for eventual net losses depends upon factors which cannot be assessed until or after a bank has actually failed. The Corporation's entire Deposit Insurance Fund and borrowing authority are available, however, for such contingencies.

Depreciation. The Washington Office Buildings are depreciated on a straight-line basis over a 50-year estimated life. The San Francisco Condominium Offices are depreciated on a straight-line basis over a 35-year estimated life. The cost of furniture, fixtures, and equipment is expensed at time of acquisition.

Income Maintenance Agreements. The Corporation records its liability under an income maintenance agreement at the present value of each estimated cash outlay at the time the agreement is accepted. Estimated cash outlays are anticipated future payments the Corporation will provide to offset the difference between the annualized cost of funds and the annualized return on the declining volume of earning assets acquired in a merger transaction, plus an amount to cover overhead costs. The charge is recorded to insurance loss. The present value of the liability is then accreted daily and recorded monthly over the term of the agreement. Any differences between the estimated and actual cash outlays are recorded as payment adjustments. The present value of remaining estimated cash outlays is also reviewed and adjusted each year when interest rate changes occurring in the marketplace appear material or permanent in nature. The originally recorded loss, plus or minus any payment and present value adjustments, will then be prorated between insured banks and the Deposit Insurance Fund as provided in Section 7(d) of the Federal Deposit Insurance Act.

Reclassifications. Reclassifications have been made in the 1983 Financial Statements to conform to the presentation used in 1984.

2. U.S. TREASURY OBLIGATIONS:

All cash received by the Corporation which is not used to defray operating expenses or for outlays related to assistance to banks and liquidation activities is invested in U.S. Treasury securities. The Corporation's investment portfolio consist of the following (in thousands):

		December 31, 1984		December 31, 1983	
Maturity	Description	Book Value	Market Value	Book Value	Market Value
One Day	Special Treasury Certificates	$ 759,127	$ 759,127	$ 484,331	$ 484,331
Less Than 1 Year	U.S.T. Bills, Notes and Bonds	2,209,252	2,226,362	1,886,210	1,884,915
1-3 Years	U.S.T. Notes and Bonds	6,186,261	6,239,531	4,985,240	4,975,485
3-5 Years	U.S.T. Notes and Bonds	5,281,646	5,216,021	5,781,924	5,621,113
5-10 Years	U.S.T. Notes and Bonds	-0-	-0-	854,354	779,366
		$14,436,286	$14,441,041	$13,992,059	$13,745,210

3. CERTIFICATES AND NOTES RECEIVABLE FROM INSURED BANKS:

The Corporation's outstanding principal balances on certificates and notes receivable from insured banks are as follows (in thousands):

	December 31 1984	December 31 1983
Certificates:		
Net worth certificates	$348,342	$ -0-
Allowance for losses	(182,981)	-0-
	$165,361	-0-
Notes receivable to:		
Assist operating banks	27,000	27,000
Facilitate deposit assumptions	93,374	120,993
Facilitate merger agreements	275,148	275,648
	$560,883	$423,641

The net worth certificate program was established at the FDIC by authorization of the Garn-St Germain Depository Institutions Act of 1982. Under this program, the Corporation would purchase a qualified institution's net worth certificate and, in a non-cash exchange, the Corporation would issue its non-negotiable promissory note of equal value. The total assistance outstanding to qualified institutions as of December 31, 1984 and 1983 is $578,791,000 and $376,866,000 respectively. As of December 31, 1984, the Corporation has recorded $348,342,000 of net worth certificates for which an allowance for losses of $182,981,000 is estimated. The financial statements exclude $230,449,000 of net worth certificates for which no losses are expected because of the non-cash exchange nature of the transactions.

4. ASSETS ACQUIRED IN ASSISTANCE TO AN INSURED BANK:

On July 26, 1984, the FDIC, the Federal Reserve Board, the Comptroller of the Currency and a group of major U.S. banks agreed to provide a "permanent assistance program" to the Continental Illinois National Bank and Trust Company of Chicago ("CINB") and its parent, Continental Illinois Corporation. This program, which became effective on September 26, 1984 after Continental Illinois Corporation shareholder approval, replaced a temporary, emergency assistance package among the same parties that had been in effect since May 1984. Major elements of the new package included a financial assistance plan to remove problem loans from CINB and infuse new capital resources into CINB, the continuation of on-going lines of credit from the Federal Reserve Board and a group of major U.S. banks to alleviate liquidity pressures and the installation of a new management team. Additionally, the FDIC agreed to commit more capital or other forms of assistance if the permanent assistance program proves to be insufficient for any reason.

4. ASSETS ACQUIRED IN ASSISTANCE TO AN INSURED BANK: (Continued)

The key aspects of the permanent assistance program applicable to the FDIC are embodied in an Implementation Agreement and an Assistance Agreement between the FDIC and CINB, Continental Illinois Corporation, and Continental Illinois Holding Corporation, a new holding company formed to own all Continental Illinois Corporation stock as of the effective date for the purpose of implementing the FDIC Option (described below). Discussed below are the major aspects of the FDIC's participation in the permanent assistance program and their effect on the FDIC financial statements.

The assets acquired by the FDIC in assistance to CINB on the commencement date and as of year end are as follows (in thousands):

	(Commencement Date) September 26, 1984	December 31, 1984
Loans and related assets purchased	$2,000,000	$2,010,313
Promissory note	1,500,000	1,447,116
Preferred stock investment	1,000,000	1,000,000
	$4,500,000	$4,457,429

Loans acquired were selected by CINB with the restrictions that such loans were nonperforming, classified or otherwise of poor quality (i.e., "troubled loans"). Certain foreign loans were excluded from selection. On September 26, 1984, after consumation of the permanent assistance program, CINB transferred $2.0 billion of troubled loans to the FDIC. The unpaid legal principal value of these loans was approximately $3.7 billion.

Also, on September 26, 1984, the FDIC received a promissory note from CINB for $1.5 billion. At CINB's option, the promissory note can be paid anytime within three years by transfer of additional troubled loans (subject to the above restrictions) at CINB's book value as of the date of transfer. Until such time as the promissory note is paid, interest will be charged. As of December 31, 1984, CINB transferred $52,844,000 of additional troubled loans to the FDIC as partial repayment on the original promissory note. As a result, the remaining unpaid principal balance on the note is $1,447,116,000.

The purchase of these assets was, in part, funded by the assumption of $3.5 billion of indebtedness to the Federal Reserve Bank of Chicago (FRB) on behalf of CINB. These borrowings will bear interest at specified rates established by the FRB and the U.S. Treasury. The FDIC will repay these borrowings by making quarterly remittances of its collections, less expenses, on the troubled loans. If there is a shortfall at September 26, 1989, the FDIC will make up such deficiency with its own funds.

4. ASSETS ACQUIRED IN ASSISTANCE TO AN INSURED BANK: (Continued)

The Implementation Agreement provides for the FDIC to be reimbursed each quarter for its expenses related to administering the transferred loan portfolio and for interest paid on the indebtedness to the FRB which it assumed. Thus, such costs are recorded as assets. The FDIC and CINB have entered into a service agreement whereby CINB will administer the transferred loan portfolio on behalf of the FDIC. The FDIC is also permitted to establish a special reserve account from troubled loan collections. The balance in this account, if any, reverts to the FDIC in those quarters when loan collections have been insufficient to cover interest owing on the indebtedness which it assumed. For financial accounting purposes, cash collections received on the transferred loan portfolio (plus certain other amounts) are applied quarterly in accordance with the Implementation Agreement terms, as follows: 1) to the administrative expenses paid by the FDIC; 2) to the interest owing on the assumed indebtedness; 3) to fund the special reserve account such that this account plus accrued interest thereon is at least $75 million; and 4) to principal owing under the FRB Agreement. The FDIC is entitled to receive interest on the cumulative deficiencies between cash collections and the costs incurred in administering the troubled loans and the interest on the assumed debt. Further, CINB has assigned to the FDIC all its existing and future claims against any party which may be related to any loss incurred in connection with any transferred loan.

Total cash flow consists of the above collections of principal and interest on the transferred loan portfolio, interest payments on the CINB promissory note and interest earned on daily collections. As of December 31, 1984, the FDIC received cash flow totaling $147,044,000. Cash flow was applied to administrative costs and interest expense of $3,224,000 and $94,564,000 respectively, and to establish a special reserve account balance of $49,256,000. Accordingly, total FDIC obligations for purposes of exercising the FDIC option (discussed below) are $3.457 billion. The collection results during this period should not necessarily be considered indicative of the ultimate loan portfolio collectibility.

Ultimate collection results on the transferred loan portfolio are subject to significant uncertainties because of the financially troubled nature of the borrowers and the effects of general economic conditions on their industries. Due to the number and complexity of the loans within the transferred loan portfolio, an estimate of the ultimate collectiblity has not been completed by the FDIC. Accordingly, no determination has been made as to whether or not any allowance for loss related to the CINB permanent assistance program is necessary. Consequently, none has been recorded in the financial statements for the year ended December 31, 1984. The Corporation expects to complete its initial determination of the estimated net realization on the transferred loan portfolio during 1985.

4. ASSETS ACQUIRED IN ASSISTANCE TO AN INSURED BANK: (Continued)

The FDIC holds an option to acquire up to 40.3 million shares of Continental Illinois Corporation common stock. The shares subject to the option are owned by Continental Illinois Holding Corporation, which is owned by the former stockholders of Continental Illinois Corporation. The option cannot be exercised prior to the fifth anniversary of the commencement date, September 26, 1989. Further, the option is excercisable only if the FDIC suffers a loss (disregarding any profit or loss from the FDIC's interest in Continental Illinois Corporation preferred or common stock) on the transferred loan portfolio, including unrecovered administrative costs and interest expense. If the FDIC suffers a loss, the FDIC will be entitled to retain any remaining transferred loans and to exercise the FDIC Option for one share of Continental Illinois Corporation common stock for every $20 of loss, at the exercise price of $0.00001 per share of common stock. No value has been assigned to the FDIC's right to exercise this option as of December 31, 1984. If the FDIC does not suffer any loss under the permanent assistance program, all remaining loans and other assets acquired will be returned to CINB and the option would not be exercisable.

The FDIC also purchased $1 billion of two non-voting, Continental Illinois Corporation, preferred stock issues. The proceeds of these issues were transferred to CINB in the form of a capital contribution. The Junior Perpetual Convertible Preference Stock, in the amount of $720 million, is convertible into 160 million shares of Continental Illinois Corporation common stock upon sale or transfer by the FDIC. Dividends are to be received on this preferred stock only to the extent that dividends are paid on the Continental Illinois Corporation common stock and are equivalent to that which would be paid on 160 million shares of common stock. The Adjustable Rate Preferred Stock, Class A, in the amount of $280 million, is a cumulative issue that is callable at the option of Continental Illinois Corporation. The issuer also has the option to pay dividends on this issue in the form of additional shares of this issue or cash until the third anniversary of their original issue date.

5. ASSETS ACQUIRED FROM FAILURES OF INSURED BANKS:

Assets acquired from failures of insured banks are as follows (in thousands):

	December 31	
	1984	1983
Depositors' claims paid	$ 731,288	$ 413,748
Depositors' claims unpaid	6,815	7,048
Loans and assets purchased in a fiduciary capacity	3,088,354	2,494,059
Assets purchased in a corporate capacity	377,219	386,917
	4,203,676	3,301,772
Allowance for losses	(2,060,136)	(1,309,743)
	$2,143,540	$1,992,029

5. ASSETS ACQUIRED FROM FAILURES OF INSURED BANKS: (Continued)

An analysis of the changes in the allowance for losses by account groups is as follows (in thousands):

	Depositors' claims paid	Loans and assets purchased in a: Fiduciary capacity	Corporate capacity	Total
1984				
Balance, January 1	$175,832	$ 727,362	$406,549	$1,309,743
Provision for insurance losses	(17,775)	810,036	(41,868)	750,393
Write-off at termination	-0-	-0-	-0-	-0-
Balance, December 31	$158,057	$1,537,398	$364,681	$2,060,136
1983				
Balance, January 1	$ 58,352	$213,536	$362,744	$ 634,632
Provision for insurance losses	117,480	513,826	43,805	675,111
Write-off at termination	-0-	-0-	-0-	-0-
Balance, December 31	$175,832	$727,362	$406,549	$1,309,743

6. PROPERTY AND BUILDINGS:

Property and buildings consist of (in thousands):

	December 31 1984	1983
Land	$ 4,014	$ 4,014
Office buildings	43,025	37,316
Accumulated depreciation	(5,338)	(4,361)
	$41,701	$36,969

The Corporation's 1776 F street property is subject to notes payable totaling $10,926,000 and $11,224,000 at December 31, 1984 and 1983, respectively.

7. ASSESSMENT CREDITS DUE INSURED BANKS:

Contingent upon a legislatively specified ratio of the Corporation's Deposit Insurance Fund to estimated insured bank deposits, the Corporation credits a legislatively authorized percentage (currently 60 percent) of its net assessment income to insured banks. This credit is distributed, pro-rata, to each insured bank as a reduction of the following year's assessment. Net assessment income is determined by gross assessments less administrative operating expenses and expenses and losses related to insurance operations.

The Garn-St Germain Depository Institutions Act of 1982 amended Section 7(d)(1) of the Federal Deposit Insurance Act and authorized the Corporation to include certain lending costs in the computation of the net assessment income. The lending costs are the amounts by which the amount of interest earned on each loan made by the Corporation under Section 13 of the Federal Deposit Insurance Act after January 1, 1982, is less than the amount of interest the Corporation would have earned for the calendar year if interest had been paid on the loans at a rate equal to the average current value of funds to the U.S. Treasury for the calendar year.

The computation and distribution of net assessment income credits for calendar year 1984 and 1983 are as follows (in thousands):

1984 Net Assessment Income Credits Due Insured Banks - July 1, 1985

Computation:		
Gross assessment income - C.Y. 1984		$1,319,170
Less: Administrative operating expenses	$151,201	
Merger assistance losses and expenses less amortization and accretion	135,383	
Provision for insurance losses	933,374	
Nonrecoverable insurance expenses	17,084	
Lending costs	-0-	1,237,042
Net assessment income		$ 82,128
Distribution:		
40% to the Deposit Insurance Fund	$32,851	
60% to insured banks	49,277	$ 82,128
Assessment credit due insured banks:		
Assessment credit - C.Y. 1984		$ 49,277
Assessment credits - prior years		18,271
Total credits due, July 1, 1985		$ 67,548

Effective rate of assessment for C.Y. 1984: 1/12.5 of 1% of total assessable deposits
Percent of total credits due insured banks: 5.12048% of gross assessments

7. ASSESSMENT CREDITS DUE INSURED BANKS: (Continued)

1983 Net Assessment Income Credits Due Insured Banks - July 1, 1984

Computation:		
Gross assessment income - C.Y. 1983		$1,211,440
Less: Administrative operating expenses	$135,660	
Merger assistance losses and expenses less amortization and accretion	90,123	
Provision for insurance losses	675,119	
Nonrecoverable insurance expenses	31,426	
Lending costs	8,640	940,968
Net assessment income		$ 270,472
Distribution:		
40% to the Deposit Insurance Fund	$108,189	
60% to insured banks	162,283	$ 270,472
Assessment credit due insured banks:		
Assessment credit - C.Y. 1983		$ 162,283
Assessment credits - prior years		1,756
Total credits due, July 1, 1984		$ 164,039

Effective rate of assessment for C.Y. 1983: 1/14 of 1% of total assessable deposits
Percent of total credits due insured banks: 13.54086% of gross assessments

8. LIABILITIES INCURRED IN ASSISTANCE TO INSURED BANKS:

The Corporation's outstanding principal balances on liabilities incurred in assistance to insured banks are as follows (in thousands):

	December 31	
	1984	1983
Federal indebtedness	$3,500,000	$ -0-
Promissory (exchange) notes	348,342	-0-
	$3,848,342	-0-

9. LIABILITIES INCURRED FROM FAILURES OF INSURED BANKS:

The Corporation's outstanding principal balances on liabilities incurred from failures of insured banks are as follows (in thousands):

	December 31	
	1984	1983
Federal indebtedness	$442,667	$ 811,666
Notes payable	222,813	242,293
Income maintenance agreements	187,346	192,756
Depositor's claims unpaid	6,815	7,048
	$859,641	$1,253,763

10. PROVISION FOR INSURANCE LOSSES:

An analysis of the provision for insurance losses is as follows (in thousands):

	December 31	
	1984	1983
Provision for insurance losses:		
Net worth certificates		
Current year provision	$182,981	$ -0-
Assets acquired from failures of insured banks		
Current year provision	283,219	122,450
Prior year adjustments	467,174	552,661
Termination adjustments	-0-	8
	750,393	675,119
	$933,374	$675,119

11. NONRECOVERABLE INSURANCE EXPENSES:

The Corporation's nonrecoverable insurance expenses primarily represent costs associated with (1) preparing and executing the activity in payoff cases and (2) administering and liquidating the assets purchased in a corporate capacity. As of December 31, 1984 and 1983, nonrecoverable insurance expenses included $13,136,000 and $25,211,000, respectively, of interest expense incurred on the Federal Reserve Bank of New York indebtedness related to the administering and liquidating of assets purchased in a corporate capacity.

12. LEASE COMMITMENTS:

Rent for office premises charged to administrative operating and liquidation overhead expenses were $11,947,000 (1984) and $7,393,000 (1983). Minimum rentals for each of the next five years and for subsequent years thereafter are as follows (in thousands):

1985	1986	1987	1988	1989	1990/Thereafter
$15,870	$12,385	$11,189	$9,696	$6,763	$42,278

Most office premise lease agreements provide for increase in basic rentals resulting from increased property taxes and maintenance expense.

13. RETIREMENT PLAN:

All permanent, full-time and part-time employees of the FDIC are covered by the contributory Civil Service Retirement Plan. The Corporation makes bi-weekly contributions to the plan equal to the employee's bi-weekly contributions. The retirement plan expenses incurred for calendar years 1984 and 1983 were $7,634,000 and $7,073,000 respectively.

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FINANCIAL CONDITION OF THE BANK AND THRIFT INDUSTRIES

WEDNESDAY, SEPTEMBER 18, 1985

House of Representatives,
Subcommittee on Financial Institutions,
Supervision, Regulation and Insurance,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The subcommittee met, pursuant to call at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the subcommittee) presiding.

Present: Chairman St Germain; Representatives LaFalce, Vento, Wylie, McKinney, McCollum, Wortley, Bartlett, and Roth.

Also present: Representative Thomas R. Carper of the full committee.

Chairman **St Germain**. The subcommittee will come to order.

We continue the subcommittee's hearing on deposit insurance reform this morning with the testimony of Andrew Carron, Edward Kane, James Sexton, and Stanley Silverberg. Each of these gentlemen is a nationally recognized expert on deposit insurance and financial institutions supervision and regulation. Their testimony today will be followed in future hearings by that of other acknowledged deposit insurance reform experts. Their testimony will be of great help to the subcommittee as our examination of the status of deposit insurance funds continues, and as we evaluate a number of significant restructuring proposals.

At this time, I recognize the gentleman from Ohio, Mr. Wylie, for an opening statement.

Mr. **Wylie**. Thank you very much, Mr. Chairman.

Let me begin by also welcoming our distinguished panel of witnesses. Their testimony obviously is based on many years of experience and should greatly aid us in charting the proper course for restructuring our system of deposit insurance. As I stated in my opening remarks last week, our task in the weeks and months ahead will be to insure a viable system of deposit insurance which contributes both to financial and monetary stability and is worthy of continuing public confidence.

As we heard last week, this system is being put to the test today. In my opinion this committee has initiated a proper and responsible response to the issues before us by conducting these hearings. My review of the testimony this morning tells me we have much to gain by listening carefully to the advice of this distinguished panel.

One particular bit of advice I appreciate is Professor Kane's statement. It is an effective statement, and in recognition of his admonition that to be effective is to be brief, Mr. Chairman, I will close, except to welcome my special constituent, Edward Kane, who is the professor of banking and monetary economics at Ohio State University. Professor Kane is the author of a new book, Mr. Chairman, entitled, "The Gathering Crisis in Federal Deposit Insurance," a book that another eminent scholar, Carter Galomby, says no one can afford to miss.

Professor Kane and the panel, I welcome you and certainly look forward to your testimony this morning.

Thank you, Mr. Chairman.

Chairman **St Germain**. Thank you, Mr. Wylie. Our first witness this morning will be Andrew Carron, vice president, Shearson Lehman Bros., Inc. Mr. Carron, we will put your entire statement in the record without objection. You may proceed.

STATEMENT OF ANDREW S. CARRON, VICE PRESIDENT, SHEARSON LEHMAN BROS., INC.

Mr. **Carron**. Thank you, Mr. Chairman.

Continuing with the pattern of brevity, I will not read my statement. I have submitted a rather lengthy statement that sets out in some detail my views on the range of issues that your staff posed to me.

In my oral remarks, I would like to make two points. First, I want to stress the importance of distinguishing between policy measures intended to prevent a deterioration of the deposit insurance and regulatory system, and those policy measures which would be effective in curing the problems that already exist.

Many of the proposals that are before this subcommittee have great merit for restructuring the regulatory system in the future to avoid a recurrence of the problems that we have seen over the last few years. However, I do feel that with perhaps one exception, those proposals would not be effective in dealing with the problems that we have today. That one exception is greatly increased supervision.

I think the single most important thing that could be done today to have an effect over the next year or so would be more supervisory activities, and greater powers should that be necessary. I am not a lawyer. I don't know whether the agencies have sufficient authority under their existing charters or whether it would need to be enhanced. But what they need to do is to get in there and begin to enforce the regulations and crack down on the risky players who are out there. These are the ones who have no capital, who are increasing their leverage without limit or going into risky investments, who are increasing the risk to the insurance funds.

There is, to be sure, a very large burden on the insurance funds from past problems—the interest rate cycles of earlier in the decade, the asset quality problems that followed—and that is clearly something that needs to be addressed over the next few years. However, I would put that in the category of a problem that is of known magnitude, whereas the problem that I am talking about is an increasing risk to the insurance funds that seems to be unchecked.

The second point I would make is that, as we look for means of resolving the current problem, we should not get caught up in the mechanics of the particular structure or mechanism that is going to be used to resolve the problem. Discussions about shifting the problem assets to a new corporation, bringing in the Federal Home Loan Bank System, versus increasing deposit assessments—these are simply debates about how to allocate the costs, costs which we all know are already out there.

I think that these discussions divert our attention from the main issue which is to get at these problems and to begin to solve them. I spoke with our Government agency trading desk earlier this morning, and the trader there informed me that just as a result of the discussions of shifting the problem assets to the Federal Home Loan Bank System, that the cost of borrowing to the bank system has gone up by about 25 basis points. And that is just in expectation of the possibility that this might happen.

A 25-basis-point increase in borrowing costs translates into several hundred millions of dollars of additional interest that the banking system and its members must pay over the course of the year. So I think we need to put those proposals in the proper context of simply the mechanics of resolving the problem, and not let those discussions divert our attention.

Those are the only two points I wanted to make, and I will leave it at that. Thank you.

[The prepared statement of Mr. Carron follows:]

Statement of

Andrew S. Carron

Vice President
Shearson Lehman Brothers Inc.
New York

Prepared for delivery before the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

September 18, 1985

Mr. Chairman and Members of the Committee:

My name is Andrew Carron. I am a Vice President of Shearson Lehman Brothers and Manager of Research and Analysis in the firm's Mortgage Securities Group. I have written extensively on financial institution regulation and deposit insurance. My study, *Reforming the Bank Regulatory Structure*, was published earlier this year by the Brookings Institution. I was a principal author of *Agenda for Reform*, the Federal Home Loan Bank Board's report on federal deposit insurance submitted to this committee in 1983 pursuant to the Garn-St Germain Act. In 1982 and 1983, I also served on the Bank Board's Task Force on Current Value Accounting. I therefore welcome the opportunity to present my views on the regulation and supervision of depository institutions. These are my personal opinions, and do not necessarily represent the positions of Shearson Lehman Brothers or American Express.

Many banks and thrift institutions today are operating at a loss, have insufficient capital, and have uncertain chances for survival. Some savings and loan associations continue to suffer the effects of the high market rates and low returns on assets that prevailed in the late 1970s and early 1980s. Other thrifts invested in real estate or commercial endeavors when economic growth was robust, and now find that those projects are generating insufficient cash flow in today's deflationary economy. Commercial banks that lent heavily to the agricultural, energy, and foreign sectors are also finding that some borrowers are unable to service their debt.

These developments have raised concerns at the state and federal levels over the viability of individual institutions and of the banking and thrift systems generally. Many proposals have been forthcoming to address the underlying problems. My testimony today will put into perspective the condition of the depository institutions, analyze the policy alternatives, and suggest the proper approach to the problem now facing us.

Industry Condition

There is widespread weakness in the banking and thrift industries today. The Federal Deposit Insurance Corporation has approximately 1000 commercial banks and mutual savings banks on its "problem list." Federal Home Loan Bank Board economists have calculated that more than 400 FSLIC-insured savings institutions are insolvent according to Generally Accepted Accounting Principles (GAAP). There is little doubt among analysts of these industries that the situation will get worse before it gets better.

The decline in market interest rates since the beginning of this year is often cited as a cause for optimism. The savings industry in particular has reported increasing profits over the last two years. Several points attenuate this apparent improvement:

- Despite a dramatic and sustained drop in market industry rates, current thrift industry profits are anemic by historical standards. Income as a precentage of total assets is now approximately 0.2 percent versus a range of 0.5 to 0.8 percent throughout the 1970s.
- Most of the profits have been in the form of nonoperating income rather than operating income. Nonoperating income is generated when the institution chooses to sell appreciated assets rather than discounted assets. For the nine quarters from the beginning of 1983 through March 1985, net pre-tax nonoperating income was $4.0 billion. Operating income on the same basis was only $1.3 billion. (These figures are for FSLIC-insured thrift institutions.)
- The decline in rates has not been sufficient to compensate for three years of high rates (1980-82) when the industry lost $10.7 billion before taxes. Regulatory net worth has recovered to 4.0 percent of assets, but on a GAAP basis industry net worth is approximately 3.0 percent. Tangible net worth, which excludes goodwill and intangible assets from GAAP net worth, is approximately 0.5 percent of assets.
- The improvement that has taken place is not felt uniformly across the industry. In addition to the 10 percent of the thrift industry with negative GAAP net worth another one-third have net worth below 3 percent

of assets. Institutions with RAP net worth under 3 percent are actually losing money in the current environment. For the first quarter of this year, that group lost $400 million.

The majority of banks and thrifts will be profitable, but the weakest institutions will be helped little by lower rates. Their problems are too large, and are generally unrelated to the level of rates. For the thrift industry, this reflects a change from a few years ago, when short-term high-cost liabilities had to support long-term low-rate assets. The problem today for most of the banks and thrifts in trouble is poor quality assets--that is, assets whose cash flow is insufficient to meet the debt service. Low market interest rates do not help the situation; in fact, they are a symptom of a larger problem. The deflationary economy that permits lower interest rates also retards growth in nominal incomes for farmers, real estate investors, energy developers, and foreign creditors. Lower inflation also depresses the value of the assets pledged to support many of the loans held by depository institutions. This, then, is the heart of the asset quality problem.

Regulation and Supervision

The industry's weakness is only half of the story; the regulatory response completes the picture. The present policy approach to problem institutions, particularly in the thrift industry, includes a tolerance of insolvency, blanket regulations that limit both healthy and ailing firms, and a search only for long-range solutions. The result of this approach is that there may be more risk-taking by thrifts, not less. The financial markets are already less willing to conduct business with all but the strongest lenders, and the eventual costs of dealing with the problem may increase.

A widely observed effect of a decline in soundness is an increased propensity to take risks. When an institution's failure appears probable, there is a strong incentive to increase the stakes of the game. Federal deposit insurance provides a source of leverage; when capital is gone, the leverage becomes infinite. The failing depository institution then seeks not to maximize expected profits, but rather to maximize the profitability of success regardless of the costs of failure.

Thus we see institutions entering into transactions that are fundamentally unsound, but which offer the gamble of recovery. Some firms speculate on interest rates, others on real estate values. The result, however, is the same.

The regulatory agencies have adopted a policy of forbearance, of permitting many insolvent institutions to remain in operation as long as cash flow is adequate. Only when such an institution faces a liquidity crisis do the agencies act. This practice is followed by the FSLIC and, probably to a lesser degree, by the FDIC as well. The current level of assets immediately available to the FSLIC may be inadequate to cover insured deposits at all insolvent institutions, and there would be a major drain on FDIC assets if all problem bank loans were immediately written down.

Policy Alternatives

A range of policy alternatives has been suggested to address the short-run and long-run problems of depository institution regulation. This Committee has asked for comments on twelve specific proposals. These and others may be grouped into four general categories for the purposes of discussion and analysis: (1) deposit insurance coverage (that is modified payoff, full coverage, and reduced coverage), (2) the structure of deposit insurance (that is, risk-related premiums, risk-related capital, and private deposit insurance), (3) insurance agency funding (fund recapitalization, merger of the funds), and (4) regulatory actions that affect risk-taking (subordinated debt capital, increased supervision, market value accounting, restrictions on brokered deposits).

Deposit Insurance Coverage. Deposit insurance serves many purposes. It provides unsophisticated investors with a safe asset and it also protects the stability of the financial system as a whole by reassuring sophisticated investors. While a low level of coverage is sufficient for small depositors, a much higher level is required to meet the other objective. It is frequently said that insurance relieves depositors of the need to be vigilant, and therefore contributes to excessive risk-taking by institutions. This is undoubtedly true, but it is precisely because of these protections that deposit insurance can stabilize the system. As long as we are going to have a deposit insurance system, this risk incentive will exist, and we are better off with more coverage than with less.

The modified payoff is a method of dealing with problem institutions by paying depositors no more than the insurance limit of $100,000 even when the firm is merged rather than liquidated. This policy has merit, but only because it restrains the costs of liquidation. Deposits over $100,000 are assumed to be at risk if the institution falls outside the cadre of money center and major regional institutions. The modified payoff simply gives depositors what they expected, rather than the bonus of full protection for funds knowingly placed at risk. Of course, the majority of uninsured deposits are at institutions so large that either liquidation or a modified payoff would be inconsistent with maintaining general stability.

One alternative that has received little attention is a modification of coverage to provide full deposit insurance for demand deposits and reduced coverage for all other accounts. This approach helps ensure the stability of the payments system by explicitly protecting those funds most likely to run in the event of perceived problems. At the same time, it discourages bidding for the "hot money" that drives up the cost of funds and encourages risky behavior. That is because corporate demand deposits do not bear interest, and all transactions balances impose costs on the institution in the form of reserve requirements, higher liquidity needs, and check processing charges. Yet small depositors would continue to be protected and the overall amount of insured deposits would not substantially change.

Deposit Insurance Structure. A major strain of the debates on deposit insurance reform contemplates the incorporation of risk-sensitive measurements, as is done for virtually all insurance written by the private sector for a variety of risks. Private insurers, it is noted, charge higher premiums for situations perceived to have greater risk. Alternatively, a larger deductible may be required. Thus proposals have been developed to scale deposit insurance premiums according to the riskiness of the institution. One variant, risk-related capital requirements, is analogous to the use of deductibles in the private sector. Some observers have suggested a system of full or partial private deposit insurance.

It should be noted that any plan intended to "tax" risk will have two effects that are opposite in their impacts on risk-taking. On the one hand, the rate of return on risky investments is reduced relative to safe investments; economists call this the substitution effect, and it leads to less risk-taking, all other things being equal. On the other hand, the imposition of higher charges for the riskier investments reduces the overall profitability of the firm, leading to the adoption of a riskier stance to make up the higher costs; this is the income effect. Whether the substitution effect outweighs the income effect, and therefore is successful in reducing risk, depends on the size and structure of the insurance premiums. It is by no means obvious that any such system can reduce risk-taking by undercapitalized institutions.

Private insurance suffers from its own set of limitations. There is insufficient private capital in the world's insurance firms to cover more than a fraction of the insured deposits in the U.S., so any use of private insurance would have to be supplementary to federal insurance. Once the government becomes a party, private insurers would probably decline to offer coverage, because the decision to terminate a growing risk (i.e., close a bank) would be out of the private insurer's control. Conversely, as the experiences of the private deposit insurance companies in Ohio and Maryland have shown, such coverage cannot provide the requisite degree of public assurance. Private deposit insurance is not a viable alternative to federal coverage, nor is it even a feasible supplement.

Deposit Insurance Funding. The problems of the thrift industry over the last several years have imposed substantial costs on the Federal Savings and Loan Insurance Corporation. There is serious doubt whether the available assets under current policies will be sufficient to meet all foreseeable funding requirements. Two means of addressing the problem have been suggested: merger of the FSLIC and the FDIC, to make available to the thrift industry the substantially greater assets of the FDIC; and recapitalization of the FSLIC through direct appropriations or by way of the Federal Home Loan Bank System.

Consolidation of the insurance agencies to resolve the funding problem is not an appropriate response. Because Congress has stated that the federal government will protect insured deposits without regard to the assets of the insurance agencies, the economic impact of providing insurance coverage is unaffected by the agency structure under which financial assistance may be provided. While there may be sound reasons for rationalization of the bank regulatory structure, the issue of insurance agency consolidation should be decided on the basis of long-range substantive concerns and not on short-range procedural expedients. The emerging economic environment demands corresponding changes in the regulatory structure, and those needed forms go beyond the deposit insurance agencies.

Several proposals have been forthcoming in recent weeks to provide for the recapitalization of the FSLIC. Although none has been explicitly set forth, all of the plans have one element in common: The costs of assisting, merging, or liquiding problem thrift institutions would fall on the thrift industry itself. That is because the losses associated with the problem firms would be borne by the FSLIC, the Federal Home Loan Banks, or a newly chartered entity owned by the FSLIC and the Home Loan Banks. All of these ultimately rely on savings institutions for funding--the FSLIC through deposit insurance assessments, the Bank System through the setting of loan and dividend rates, and the proposed new corporation indirectly through both. Therefore, the issue of recapitalization is about whether costs will be allocated to FSLIC-insured thrifts in proportion to deposits (insurance fees), or to all members of the Federal Home Loan Bank System (a group that include some FDIC-insured savings banks and others, as well as FSLIC members) in the form of higher charges for advances and lower dividend rates on FHLB stock. While the provision of greater liquidity from the FSLIC would assist the agency in a more rapid resolution of problem cases, the discussion of recapitalization should not divert attention to the main issues.

Regulatory Actions Affecting Risk-Taking. The regulatory agencies should be active in dealing with problem institutions. Forbearance has the pernicious effect of encouraging more risk-taking. Insolvent institutions become ever more highly leveraged. Nearly insolvent institutions see firms less healthy than themselves allowed to remain in business. Excessive risk taking is not always punished.

The many vacant senior positions at the Bank Board should be filled quickly. The quality and quantity of federal and state supervision should be increased. Supervisory agents need the training and the resources to understand more completely the wide variety of activities that banks and thrifts now undertake. They need the ability to support management's constructive efforts and the authority to forestall practices that are unsound. Managers, directors, and owners should not be led to believe that deteriorating capital, excessive risk-taking, and other such practices will be condoned. Specific policies that may affect risk-taking by depository institutions include the extent of subordinated debt capital, reliance on brokered deposits, and the use of market value accounting principles.

Capital provides a buffer between the problems of a depository institution and the accounts of its depositors. Where those deposits are insured, capital insulates the deposit insurance agency as well. A combination of equity capital and subordinated debt could provide protection for creditors and impose greater market discipline on institutions.

Subordinated debt is superior to uninsured deposits because it cannot be readily withdrawn in the event of problems. It has also an advantage over equity capital, because subordinated creditors have no opportunity to profit from an institution's adoption of a riskier investment strategy; the sophisticated investors who purchase subordinated debt will impose restraint on the institution.

It would appear that brokered certificates of deposit lack all of the attributes that make subordinated debt attractive as a risk-management tool: brokered deposits are insured, short-term, easily withdrawn, and carry rates that readily adjust to changes in the risk structure. But these undesirable characteristics are common to all insured deposits, whether acquired over the counter, by mail or telephone, or through brokers. The problems are inherent in our system of deposit insurance. Limitations on brokered deposits would inhibit the free flow of capital, reduce competition, raise the cost of acquiring funds for all institutions, and exacerbate rather than ameliorate the current problems of the banking system.

The problem, of course, is the management of risk. But even the measurement of risk is not a well-defined process. Market value accounting, one method of tracking portfolio risk, was evaluated a few years ago by a committee formed by the Bank Board. This Task Force on Current Value Accounting was composed of seventeen professionals from the regulatory agencies, thrift institutions, accounting firms, and elsewhere. The group concluded as follows:

> First, it is imperative that financial institutions and their regulators come to understand the nature of interest rate risk and the consequences that interest rate volatility can have on the profitability and viability of individual institutions. Second, the current method of historical cost accounting for financial institutions does not, in many instances, accurately portray the economic substance of transactions being made....
>
> The Task Force recommends the adoption of a system for reporting the interest sensitivity of financial assets and liabilities. Such a system should provide valuable information concerning the degree and implications of interest rate risk to institution management and regulators.

As a result of the work of the Task Force, the Bank Board began the collection of data on the maturities of assets and liabilities. This effort has already yielded much additional insight. In would be a relatively simple matter to extend this process to a full current value analysis. In fact, consulting firms already provide such computations, and investment banks perform valuations on mortgage loan portfolios offered for sale in the secondary market. The process is applicable equally to banks, thrifts, and credit unions; most nondepository intermediaries already mark their portfolios to market on a daily basis. Such information would be of great value to regulators and to the firms themselves, but public disclosure should be considered as an issue unto itself, and not as a part of the discussion on current value accounting.

Conclusions

The measures that have been proposed for preventing problems hold promise for the future, but they would be ineffective in resolving the current difficulties. Depository institutions are in a weakened and fragile condition, and financial markets are reacting to this situation. To impose new insurance costs and regulatory requirements would further impair these institutions and would risk greater instability in the markets. Before new regulations are imposed on banks and thrifts, a policy to restore strength and confidence should be implemented. The primary means of accomplishing this objective is to rationalize and reorganize the weakest firms and to discourage the marginally healthy ones from assuming excessive risks.

This is not intended to prejudge the usefulness of prudential incentives when applied to a basically healthy industry. A system that discourages risky behavior is definitely needed to maintain financial stability over the long-run. But the problems affecting the markets today require different measures.

In the case of institutions regulated by the Bank Board, it will be necessary to establish more stringent standards. More real capital should be required, and where that is not possible the agency should step in to assure safe and sound practices. This means a retreat from regulatory accounting and from lower net worth requirements. The markets already shun those institutions with no GAAP net worth or with regulatory net worth below 3 percent; regulatory agencies should do the same. Only the threat of a takeover by its chief creditor (the FSLIC) will deter those who control a weak institution from risking further large sums of money. Such an approach would do much, very quickly, to arrest the erosion of health in the industry.

Chairman **St Germain**. Now we will hear from Edward Kane, professor of banking, Ohio State University. Again we will put your entire statement in the record, Professor Kane, and you may proceed.

STATEMENT OF EDWARD J. KANE, PROFESSOR OF BANKING, OHIO STATE UNIVERSITY

Mr. **Kane**. Thank you, Mr. Chairman, and thank you also, Mr. Wylie. I appreciate this chance to discuss deposit insurance reform with people who can make it happen. I can summarize my testimony in five sentences. Two interrogative and three are declarative.

If I were more flamboyant, I would have had each sentiment emblazoned on a T-shirt or bumper sticker:

First. Who insures your deposit insurer?

Second. Honk if you like Government bailouts.

Third. Do you care where insured deposits go after you drop them off?

Fourth. Banking holidays give no cause for celebration, and

Fifth—and this is a major focus of my testimony—insolvent institutions don't come clean.

Some important economic analysis underlies each of those statements. Let's take them one at a time. Who insures the deposit insurers? The answer is taxpayers and well-capitalized financial institutions. Whether we realize it or not, the economic resources of any taxable party may be called upon to back up the inadequate resources of State-sponsored and Federal deposit insurers.

Second, the Government bailouts that are implied in this system should leave taxpayers and well-capitalized financial institutions unhappy with the myopic policies of insolvency resolution being followed today. These policies inappropriately subsidize shortrun deposit-institution risk-taking in ways that subject the size of everyone's future tax bill to a growing loss of longrun control.

Third, depositors should care where their deposits go, but deposit-insurance subsidies undermine market discipline. When deposit-institution creditors see themselves as fully insured, they have no incentive to worry about what their bank does with the funds they entrust to it. However, people are beginning to realize the wisdom of diversifying at least across deposit insurers today. This in itself should be a somewhat frightening event for government officials.

Fourth, nobody celebrates banking holidays. As events in Ohio and Maryland have underscored for us all, the perceived burden of a deposit insurance agency's guarantees can suddenly outgrow its resources. When this happens, the quality of the assets supporting an institution's deposits makes all the difference as to whether households can continue to get at their deposits without restriction or loss. For this reason, prudent deposits—as well as Government officials responsible for protecting taxpayers of every kind—should want to monitor the true economic condition of any deposit institution with which they do business. Unfortunately, current accounting principles make effective monitoring practically impossible.

This brings us to the fifth aphorism, which observes that economically insolvent institutions inevitably strive to conceal their insolvency. Due to inadequacies in contemporary principles of financial accounting, historical cost records can legally conceal adverse developments. Shrewd managers of deposit institutions and deposit insurance agencies that are economically insolvent can maneuver to overstate their capital without fear of civil or criminal penalty.

One of my favorite cartoons shows two accountants laughing uncontrollably at an audit report that says two plus two equals seven. If this is funny, the cumulative overstatement of capital by banks and thrift institutions in recent years is the stuff of which even more absurd accounting jokes can be made.

These reports make claims of the form that two minus five is still two. Few deposit institutions have formally recognized the extent to which their capital has been impaired by troubled loans to farmers and less developed countries or by capital losses on their holdings of low-rate mortgages.

Moreover, in accounting for their own reserves, deposit insurers themselves play the same game. They almost completely ignore fluctuations in the market value of the financial guarantees they have outstanding. The value of these guarantees ought to be carried on the books of insured and insurers alike.

Only a carefully balanced package of multiple reforms can wring Federal subsidies out of Federal deposit insurance. Ideally, a series of complementary changes need to be made: in deposit insurance pricing and coverage, in insurance-agency accounting systems, monitoring systems, disciplinary powers, and foreclosure and cancellation rights, and in the extent to which private firms and Federal agencies compete for deposit insurance customers.

Assuming that Congress is not yet ready to overhaul the deposit insurance system fully, I wish to promote, as a second-best option, a single reform that would go a long way toward rationalizing existing patterns of control as well as strengthening most of the reforms that your subcommittee is considering today. This key step has two parts: First, reports of deposit institution assets and liabilities should be made at market value and include sources of value that are now regarded as off-balance-sheet items—and second, exactly the same accounting principles should apply to desposit insurers and their guarantees.

Adopting this reform would simultaneously increase private market discipline and sharply alter the now-pathological politics of the insolvency-resolution process. In particular it would increase incentives to use modified payoffs and temporary trusteeships. It should force the value of an institution's guarantee to become the centerpiece for supervisory action at institutions that are insolvent de facto. Authorities will come under pressure to close institutions that fail to adopt policies that over time lower this value of the guarantee.

Historically, the FDIC and FSLIC have relied on implicitly risk-based capital requirements and ex post regulatory penalties to deter excessive risktaking. Unfortunately, these agencies' existing monitoring systems measure their clients' capital inappropriately and the agencies' existing approach to resolving de facto insolvencies is too timid.

As a result, the penalty system is full of loopholes. To close these loopholes, capital requirements and administrative sanctions of other kinds must be made more sensitive to the risks that insured institutions actually impose on deposit institutions and through them the taxpayers.

This requires that more meaningful information be collected from institutions on the extent and character of their risk exposure and that authorities keep their own books in ways that permit taxpayers and well-capitalized client institutions to monitor the true costs of the insolvency-resolution policies that are followed.

Two subtle distributional costs of the deposit insurance subsidy are to favor the deposits of the Nation's largest banks over those of smaller institutions and to expand the Federal regulatory sector unfairly and inefficiently at the expense of State and self-regulatory monitoring systems. In my judgment, bringing these and other costs into the open would lead taxpayers to assert their economic interests in deposit insurance transactions and to defend their rights politically. Once they know the stakes, few taxpayers will want to remain silent partners in a series of poorly structured long-shot bets.

Misadministering Federal deposit insurance forces us all into an insurance pool with daredevil operators. I, for one, want out.

Thank you, Mr. Chairman.

[The prepared statement of Professor Kane with an attached paper entitled "Confronting Incentive Problems in U.S. Deposit Insurance: The Range of Alternative Solutions" follow:]

U.S. House of Representatives,
Subcommittee on Financial Institutions
Supervision, Regulation and Insurance of the
Committee on Banking, Finance and Urban Affairs
Hearings on Deposit Insurance Reform
September 18, 1985

MARKET-VALUE ACCOUNTING AS DEPOSIT-INSURANCE REFORM

Edward J. Kane*

Previous stints of testifying before Congressional committees have taught me the value of brevity. Effective testimony is brief testimony. Busy legislators are looking for a series of short sentences that serve to define the relevant policy problem, measure its extent, and offer a solution. To capture the interest of the press, these sentences should be bright and catchy statements of the kind suitable for inscribing on a tee shirt or bumper sticker. Although such one-liners must inevitably be a shade playful, they ought to emphasize wit and irony (i.e., food for thought) over sheer corn.

With this in mind, I wish to put into the record five statements that explain the need for deposit-insurance reform. Several of them also hint at lines of reform:

1. Who insures your deposit insurer?
2. Honk if you like government bailouts.
3. Do you care where insured deposits go after you drop them off?
4. Banking holidays give no cause for celebration.
5. Insolvent institutions don't come clean.

1. Nature of the Problem

I hope to convince you that some important economic analysis is embodied in these one-liners. First, the parties that actually ultimately insure the deposit insurers are two: ordinary taxpayers and well-capitalized financial institutions whose investment policies are sound enough to let them survive a major crisis of confidence. Whether we realize it or not, the economic resources of any taxable party may be called upon to back up the pitifully inadequate resources of state-sponsored and federal deposit-insurance corporations. Second, as second-tier insurers, taxpayers and well-capitalized financial institutions should be unhappy with the myopic policies of insolvency resolution being followed today. These policies inappropriately subsidize short-run deposit-instituion risk-taking in ways that subject the size of everyone's future tax bill to a growing loss of long-run control. Third, deposit-insurance subsidies undermine market discipline. When deposit-institution creditors see themselves as fully insured, they have no incentive to worry about what their bank does with the funds they entrust to it. Fourth, as partial banking holidays in Ohio and Maryland have underscored for us all, the perceived burden of a deposit insurance agency's guarantees can suddenly outgrow its resources. When this happens, the quality of the assets supporting an institution's deposits makes all the difference as to whether depositors can continue to get at their deposits without restriction or loss. For this reason, prudent depositors (as well as government officials responsible for protecting second-tier deposit insurers of every kind) should want to be able to monitor the true economic condition of any deposit institution with which they do business.

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This brings us to the fifth aphorism, which observes that economically insolvent institutions inevitably strive to conceal their insolvency. Due to inadequacies in contemporary principles of financial accounting, historical-cost accounting records can legally conceal adverse developments. Shrewd managers of deposit institutions and deposit-insurance agencies that are economically insolvent can maneuver to overstate their capital without fear of civil or criminal penalty.

The cumulative overstatement of capital by banks and thrift institutions in recent years is the stuff of which accounting jokes are made. Few deposit institutions have formally recognized the extent to which their capital has been impaired by troubled loans to farmers and less-developed countries or by capital losses on their holdings of low-rate mortgages. Moreover, in accounting for their own reserves, deposit insurers themselves play the same game. They almost completely ignore fluctuations in the market value of the financial guarantees they have outstanding. The value of these guarantees ought to be carried on the books of insureds and insurers alike.

A mild example of deposit-insurer cosmetic accounting was reported on the front page of the August 2, 1985 Wall Street Journal in its "Washington Wire" column:

> MISSING ITEM: The FDIC omits from its annual report a qualified audit opinion by the General Accounting Office for not setting up a reserve for $2.1 billion in troubled loans acquired from Continental Illinois Bank. "Waiting for the GAO report," an FDIC spokesman explains, "would have slowed down production on the annual report."

Faced with a far more severe shortage of reserves occasioned by an indigestible lump of client insolvencies, the FSLIC has adopted the even less-satisfying expedient of delaying its annual reports. The 1983 report was not published until December, 1984 while its 1984 annual report is still not available.

2. A Key Element That Belongs In the Forefront of Any Reform Package

No simple formula exists for cleaning up the deposit-insurance mess. Only a carefully balanced package of multiple reforms can wring federal subsidies out of federal deposit insurance. A series of complementary changes need to be made: in deposit-insurance pricing and coverage; in insurance-agency accounting systems, monitoring systems, disciplinary powers, and foreclosure and cancellation rights; and in the extent to which private firms and federal agencies compete for deposit-insurance customers.

Assuming that Congress is not yet ready to legislate a thorough overhaul of the deposit-insurance system, I want to promote, as a second-best approach, a single reform that would go a long way toward rationalizing existing patterns of control. This key step would be to require market-value accounting for: (1) deposit-institution assets and liabilities (including sources of value that have been traditionally regarded as off-balance-sheet items) and (2) deposit-insurer guarantees. Adopting this reform would simultaneously increase private market discipline and sharply alter the now-pathological politics of the insolvency resolution process, increasing the use of modified payoffs and temporary trusteeships. It should force the value of the guarantee to become the centerpiece for supervisory action at institutions that are insolvent de facto. Authorities would come under pressure to discipline institutions whose policies keep or make this value high.

To get dirty clothes to come clean, modern laundries employ detergents that break out insoluble foreign matter and hold it in suspension. To get insolvent deposit institutions and deposit-insurance agencies to come clean about their economic condition, authorities need to adopt detergent principles of accounting and insolvency resolution.

Historically, the FDIC and FSLIC have relied heavily on risk-based capital requirements and on ex post regulatory penalties to deter excessive risk-taking. Unfortunately, these agencies' existing monitoring system fails to measure their clients' solvency appropriately and their approach to resolving existing insolvencies is too timid. As a result, operative risk-deterrence policies are full of loopholes, loopholes through which clever managers may duck most of the intended penalties. To close these loopholes, effective capital requirements and administrative sanctions of other kinds must be made more sensitive to the risks that insured institutions actually impose on deposit insurers. This requires that more meaningful information be collected from institutions on the extent and character of their risk exposure and that authorities keep their own books in ways that make it easier for taxpayers and well-capitalized client institutions to monitor the true costs of the insolvency-resolution policies that are followed.

Two subtle distributional costs of the deposit-insurance subsidy are to favor the deposits of the nation's largest banks over those of smaller institutions and to expand the federal regulatory sector unfairly and inefficiently at the expense of state and self-regulatory monitoring systems. In my judgment, bringing these and other costs into the open would lead taxpayers to assert their economic interest in deposit-insurance transactions and to defend their rights politically.

3. Winners and Losers from Nondisclosure

I believe that bureaucratic lags and deposit institutions' and federal regulators' common desire to hide the full effect of interest volatility on the size and distribution of the deposit-insurance subsidy from taxpayer scrutiny explains why market-value accounting was not adopted long ago. Subsidies are most likely to be hidden when their sponsors think that they would be hurt by public disclosure of the size and distribution of the subsidies in question. Beneficiaries must doubt that the public-policy case for the subsidy is strong enough to survive the bright sunshine of open scrutiny.

Regulatory reform is a game that pits specific beneficiaries against generalized taxpayers. It is important to recognize just who benefits and who loses from not calculating and explicitly disclosing the market value of the guarantees and bailout aid furnished to troubled deposit institutions. Two primary beneficiaries of nondisclosure exist: stockholders and managers of the nation's riskiest deposit institutions and top-level deposit-insurance bureaucrats who are able to simplify their jobs and improve their public standing by ducking emergent problems and leaving them for their successors to reveal and solve. The size of the benefits flowing to managers and stockholders of a given institution increases with the business and portfolio risks it assumes and (because authorities are loath to liquidate large institutions) with the size of the institution. Benefits decrease with the extent to which competition among insured institutions for subsidized loan and deposit-taking opportunities shifts the subsidy to borrowers, depositors, and brokers of various types. The losers consist of taxpayers and less-risky financial institutions.

Misadministering federal deposit insurance forces us all into an insurance pool with daredevil operators. I, for one, want out.

For MAI Conference Volume,
Meeting The Challenge of Change
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CONFRONTING INCENTIVE PROBLEMS IN U.S. DEPOSIT INSURANCE: THE RANGE OF ALTERNATIVE SOLUTIONS*

Edward J. Kane**

Federal deposit insurance operates as a disequilibrium system. Explicit premiums (i.e., fees paid in dollars) are calculated as a fixed percentage of domestic deposits. For forms of portfolio risk that complementary supervisory activity does not appropriately penalize, this leaves the deposit-insurance agencies (principally the FDIC and FSLIC) offering insurance on cheaper terms than the market is prepared to pay institutions for assuming these risks in the first place. To offset the subsidy to risk-bearing that this structure of explicit premiums creates, deposit-insurance personnel have to monitor client risk-taking and impose a series of administrative penalties on clients that they observe to be taking what shape up as inappropriate risks. It is convenient to think of these penalties as implicit premiums.

This two-part pricing system has two serious weaknesses. First, political restraints invevitably protect particular forms of risk-bearing such as housing and agricultural loans. Second, inescapable lags in recognizing the implications for agency risk exposure of emerging categories of client risk-taking reward deposit-institution managers for discovering innovative (and therefore unregulated) forms of bearing risk.

Unregulated risks are not only subsidized, they are largely unfunded. The burden of backing up FDIC and FSLIC guarantees falls implicitly on the general taxpayer and on any conservatively managed institution that chooses to resist the siren call of subsidized opportunities for aggressive risk-bearing.

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*This paper draws heavily on Chapter 6 of The Gathering Crisis in Federal Deposit Insurance (Cambridge, Mass.: MIT Press, 1985).

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This study argues that generally accepted accounting principles -- which allow deposit institutions to carry underwater assets at historical cost and prevent the value of FDIC and FSLIC guarantees from being booked -- routinely distort public perceptions of deposit-institution earnings and capital and understate the cost of the federal government's commitment to bail out troubled banks and S&Ls. In the face of an increasingly risky economic environment, the absence of effective taxpayer discipline on regulators and elected politicians who permit the market value of deposit-insurance guarantees to grow leaves the value of these guarantees out of administrative control. Because the distribution of implicit taxpayer responsibilities for redeeming unfunded deposit-insurance guarantees differs sharply from the apparent distribution of the benefits of deposit insurance (which figure to grow with accountholder wealth and to be greatest for the stockholders and creditors of very large institutions), this lack of control is not politically sustainable.

Whenever opportunities for institutional risk exposure expand, lags in regulatory response permit the deposit-insurance subsidy to risk-taking to grow, increasing the fragility of our financial system. To cut back incentives for voluntary risk-taking, it is necessary to reprice and to redesign the existing system of deposit-insurance coverage. The FDIC and FSLIC must develop incentive-compatible insurance contracts and monitoring arrangements and price their guarantees fairly. Under current arrangements, low-risk deposit institutions are asked to pay unreasonably high premiums for deposit insurance, while high-risk institutions are offered bargain rates. To limit insured institutions' opportunities for an adverse selection of risks, contractual incentives need to be established to allow a would-be low-risk institution to lower its effective premium by communicating the confidential information that its own managers possess about the institution's true exposure to both traditional and nontraditional forms of risk.

We may liken the current federal system of deposit insurance to an old and undermaintained automobile that after years of hard, but reliable service is nearing a serious breakdown. In recent years the deposit-insurance car has become a smoke-belching jalopy that is being driven at high speeds up and down a series of steep interest-rate mountains and over unpaved backroads in agricultural regions of the U.S., in less developed countries, and in energy-exploration regions all over the world. Because it has taken so much abuse, the deposit-insurance jalopy ought to be traded in before it lets its passengers down at an inopportune time.

This metaphor has two instructive features. First, it implies that the largely trouble-free operation that the deposit insurance system delivered during its first forty or fifty years is of no current relevance. In ignoring the momentum of the system, defenders of the status quo act like a pair of government building inspectors that accidentally tumbled off the roof of a 60-story building. Devoted to duty until the very end, as they fell past the top 50 floors, they loudly reassured each other and the building's occupants, "So far, so good." Whatever good the system has accomplished in the past, politicians and taxpayers need to recognize that its momentum is carrying it in the direction of a bureaucratic disaster exemplified by the breakdown of the Ohio system for guaranteeing 70-odd S&Ls in March, 1985. When the Ohio Deposit Guaranty Fund was exhausted by a single failure, state authorities resisted for a few weeks political pressure either to supply credible deposit guarantees for the Fund's other 70 member institutions or to idemnify the FSLIC against liabilities it might incur from accepting responsibility for insuring these institutions. This led to serious runs on the weakest of the survivors, which frightened state authorities sufficiently to call a banking holiday that temporarily shook confidence in state-insured S&Ls and even federally insured thrifts in the rest of the country. Unless market discipline is reimposed on deposit institution risk-taking, the federal deposit insurance bureaucracy is eventually going to encounter similarly mismanageable obstacles. Eventually, one of these will be mishandled badly enough to call the credibility of federal guarantees into question.

Second, it is instructive to liken the problem of selecting a new framework for deposit insurance to the process of shopping for a new car. Given dealer prices, the main question is what features to have installed on the new-model insurance system —either immediately or in stages. Options available on both insurance contracts and cars expand secularly. Cruise control, pneumatic shock absorbers, power steering, power brakes, automatic transmission, remote releases for hood, trunk and gas caps, power locks and power antennas did not even exist in 1933. Systems of risk appraisal, risk sharing, and risk management have improved in parallel fashion. After years of driving an antiquated car, a potential buyer needs guidance as to which of many apparently luxury options a contemporary driver should regard as practical necessities. This paper's program for deposit insurance reform is conceived as a six-category catalog of optional technological improvements that knowledgeable federal taxpayers might ask politicians to include on the new deposit insurance invoice.

In an economic environment in which deposit institutions are highly levered and entering new businesses every day and in which interest rates are highly volatile, systematically mispricing deposit insurance guarantees encourages deposit institution managers to position their firms on the edge of financial disaster. Metaphorically, deposit-insurance authorities are paying deposit-institution managers to overload the deposit-insurance jalopy, to drive it too fast, and even to break dance on its hood as it careens through interest rate mountains and over back-country roads. Reformers' ultimate goal must be to confront institutions whose risk-taking imposes socially unacceptable risks on its federal guarantors with a combination of reduced coverages and increased fees sufficient to move them to adopt safer modes of operation. Their proximate aim should be to make the FDIC and FSLIC act more like private insurers, so that they better protect their and federal taxpayers' economic interests, treat large and small institutions more equally, and make uninsured creditors (including large depositors) and stockholders bear more of the risk inherent in deposit institution operations. This probably involves making much more room for private and even interagency competition in the provision of deposit insurance.

Although politicians and regulators prefer to minimize failures during their term in office, if deposit institution risk-taking is to be controlled over the long run, it is necessary to expand opportunities for troubled individual institutions to experience runs and even to fail. Economic analysis indicates that as deposit-institution managers and customers more fully appreciate the extent of implicit or de facto federal guarantees, continuing to rescue insolvent firms becomes counter-productive. In the long run, regulatory efforts to prevent de facto deposit institution insolvencies from becoming de jure insolvencies increase the size and extent of de facto insolvencies in the depository industry.

Six-Point Catalog for Deposit Insurance Reform

The adjustments needed must include at least some of six basic changes in federal deposit insurance contracts (Kane 1983). Viewing these proposals as six desirable features available to purchasers of new-model automobiles should clarify that this program is not conceived as an all-or-nothing package. Although the various elements in the package complement each other, adopting any subset of the reforms suggested should provide a better deposit insurance system, one whose operation would be smoothed by the improved system of risk-taking incentives.

Market-Value Accounting

The heart of various deposit insurance dilemmas is that a deposit institution's managers have more and better information about the riskiness of their firm's operations than its insurers and customers do. Since 1938 generally accepted accounting principles and regulator-imposed accounting rules have authorized deposit institutions to employ so-called "intrinsic-value accounting," which permits assets whose scheduled cash flows are relatively current to be carried at book value. Reinstituting market-value accounting for deposit-institution loans and investments can be justified as an administratively cheap scheme for raising the implicit regulatory premium on deposit insurance in a risk-sensitive way. The most attractive aspect of this approach is that it makes traditional capital requirements and other elements of the implicit premium more effective, while letting market forces help bureaucrats to conduct regular assessments of an institution's risk exposure and to impose appropriate penalties on overly aggressive risk takers.

That muggers and burglars prefer to work in the dark is reason enough to propose brighter lighting. In a world where declines in market value are not obscured by book-value accounting, deposit-institution managers who contemplate aggressively pursuing unregulated risks would know that they would have to defend their risk-taking strategies against regulator and financial-analyst criticism and to offer correspondingly higher interest rates to uninsured depositors. Moreover, when and if these risks go awry, they would face quicker and more extensive damage to their careers and to the stock price and deposit flows of the institution they manage.

Contemporary accounting principles relieve managers that report book values (and absolves their outside accountants as well) from legal liability for communicating less than their best estimate of the value of an institution's portfolio. Legal authority to use book-value accounting to cover up adverse information gives financial-institution managers (especially unscrupulous ones) too much discretion over the extent to which current problems show up on an institution's income statement and balance sheet. This managerial discretion puts the burden of valuing deposit institutions on financial analysts such as David Cates and Harry Keefe and weakens the effect of market and political controls that would otherwise discipline institutions' and insurers' risk exposure. Having to worry about how insurers and depositors might respond to quick-breaking news about potentially injurious developments would establish incentives for deposit-institution managers to modify and to bond their behavior in helpful ways. Even after the FDIC issued blanket guarantees of Continental Illinois liabilities in May 1984, institutional investors governed by prudent-man rules continued to withdraw maturing funds from the bank. The bank's market for letters of credit dried up as well.

If private parties are to bear more of the risk inherent in a de jure failure, accountants owe investors in deposit institutions and coinsuring depositors (those that are less than fully insured) a best-efforts estimate of the risk exposure and changing market value of the assets and liabilities that deposit institutions hold on their books. Investors and insurers need reliable information on the value of unrealized losses and gains at financial institutions, information of the sort that conscientious deposit-institution managers should be assembling and analyzing in the course of operating their firms. To produce estimates that would be accurate to within a few percentage points of market value, accountants need only to expand their concept of the bookable assets and to supplement their more-traditional bean-counting skills by developing and deploying reasonable competence in asset appraisal. As in real-estate appraisal, to value an asset that does not trade, an analyst must rely heavily on data covering current yields and prices in secondary markets for comparable investments. As collateralized instruments develop for more and more kinds of cash flows, the range of available data becomes richer and richer. For an institution as a whole, as long as unbiased appraisal techniques are employed, errors in valuing the individual assets in its portfolio should tend to cancel out. A major role for government examiners would be to determine whether or not deposit-institution managers and accountants are in fact employing appraisal techniques that are unbiased.

To estimate the value of mortgages and directly placed loans (such as those to troubled farmers, energy firms and less-developed countries), the major problem is to assess the reliability of lender projections of future cash flows and to obtain reliable estimates of appropriate market discount rates to use as inputs into present-value formulas. Practical implementation of these formulas has been greatly simplified by software that preprograms the necessary calculations onto floppy discs or hardwires them into the circuits of hand-held calculators.

If federal deposit insurers wanted to develop rather than to conceal such information, they could expand the set of transactions observed in secondary markets. Specifically, they could request their liquidation divisions to arrange for periodic auctions of assets chosen for their inherent comparability to the most important classes of hard-to-value instruments currently being held by troubled institutions. They could also set up a self-regulatory board to help identify emerging types of unbookable assets and to determine what valuation principles and procedures should apply.

Until very recently, neither government nor industry has wanted to publicize base-line values for troubled assets. Although we may cite some tentative administrative steps in the direction of greater disclosure, backsliding continues to occur with respect to politically protected risks. On the plus side, authorities have required banks to report their positions in troubled foreign loans and required S&Ls to report gaps between the interest sensitivity of their assets and liabilities. In 1984, the SEC and Comptroller of the Currency specifically forced several large institutions to restate their 1983-84 profits in a less self-serving manner. However, authorities have encouraged cosmetic accounting by permitting problem loans to less-developed countries to be carried at book value and by promising to take a "flexible" approach to valuing distressed farm loans at banks located in agricultural regions.

Opponents of greater disclosure offer two objections: first, that the costs of providing market appraisals might exceed the benefits and, second, that outside parties might dangerously misinterpret the accounting reports that result. Even though market-value accounting promises to increase the costs and complexity of outside audits, it should improve decision making at any firm whose internal information system does not already employ market value data. In addition by simplifying the tasks of financial analysis and of deposit institution examination, it should release appreciable amounts of resources elsewhere in the financial industry. Opponents of market value accounting worry that it will increase fluctuations in reported earnings; however, by making changes in the portfolio values public, it creates incentives for managers to adopt policies that make the true value of these fluctuations smaller. Moreover, because capital markets must estimate current values in any case, better estimates of portfolio values may reduce (at least on average) the size of allowances that market participants make for the uncertain cosmetic nature of reports of institutional earnings and capital positions. Today, the need to allow for the degree of managerial artfulness permitted in assembling information for reports prepared under principles of historical-cost accounting makes investors discount the reported earnings of even conservatively managed institutions.

On the regulatory side, if taxpayers were well-informed, political pressure would have led Congress long ago to insist that deposit insurers collect market-value reports. Such information would help regulators to discover and to resolve problem situations more quickly and generate popular pressure on authorities to make more timely and better focused interventions. As long as deposit-insurance agencies remain free to offer capital assistance to failing clients, market-value accounting would merely curtail rather than eliminate regulatory discretion as to whether and when to close an economically insolvent institution. However, by forcing more timely and more explicit forms of intervention, market-value accounting would reduce an insolvent institution's opportunities for pursuing go-for-broke strategies.

Accounting standards that make it ethical for individual deposit institutions to disguise insolvency and risk-taking beyond all recognition undermine the effectiveness of existing capital requirements. Until these standards are changed, proposals to solve the deposit insurance problem by raising or restructuring deposit institution capital requirements may have effects that are more cosmetic than real.

Expanded Opportunities for Deposit Insurance Agencies to Manage Risk Exposure

To neutralize political pressure for forbearance, deposit insurance agencies need enhanced rights and a greater determination to take timely action on three fronts: to force institutions to maintain the market value of their capital accounts, to cancel the insurance coverage of aggressively managed institutions, or to foreclose on the bank's charter before the market value of an institution's net worth is exhausted. The goal of this class of reforms is to make the current disequilibrium system less breakdown prone by making it easier to prevent institutions that are insolvent de facto from making spectacularly risky endgame plays with FDIC and FSLIC (i.e., taxpayer) money. In recent years so many failing institutions have made last-ditch maneuvers with insured brokered funds that aggressive deposit brokers appear to do a better job of identifying insolvent institutions than FDIC and FSLIC examiners do.

Of course, because insurers may track the same data on CD yields to which customers of CD brokers respond, this appearance is illusory. The jibe has force only because problem situations persist long after the desirability of preserving FDIC and FSLIC insurance reserves should have led the insurer to demand an institution's closure. This delay, which intensifies agency exposure to go-for-broke speculation by failing firms, traces in part to statutory constraints on FDIC and FSLIC problem-solving options. Unlike automobile insurers who routinely cancel their coverage of drivers they deem to be poor risks, the deposit-insurance agencies do not have the right to terminate an institution's insurance on short notice. For example, unless a problem bank neglects to exercise some of its rights of appeal, it takes the FDIC a year to start to terminate its insurance of new deposits, while the process of fully phasing out its guarantees on a bank's existing deposits absorbs two more years. In 1983, the FDIC initiated a record-high 26 termination-of-insurance proceedings.

Nor do insurers have the right to close an institution they deem legally or economically insolvent. They may, of course, petition the institution's federal or state chartering authority to declare a legal insolvency. However, the interests of this second agency in resolving the problem typically differ importantly from that of the insurer. For federal S&Ls and some federal savings banks, this tension is contained within a single building, as the FHLBB balances the narrow economic interest of the FSLIC against broader political concerns that impact the Board. However, whenever an insured S&L holds a state charter, its chartering authority must also be brought into the negotiations. For the FDIC, conflicts of interest also vary with the character of the regulatory climate chosen by the client. For national banks, the primary regulator and chartering authority is the Comptroller of the Currency. (However, in December 1983, the Comptroller agreed to give the FDIC blanket authority to examine all national banks whose condition falls in the lowest two categories of the agencies' five-point rating scale.) For FDIC-insured federal savings banks, the FHLBB holds regulatory and chartering authority. For state-chartered commercial banks that belong to the Federal Reserve System, the Fed is the primary federal regulator, but not the chartering authority. This means that, to close such a bank, the FDIC must rely on information developed by the Fed and deal both with its state banking commissioner and officials from the Fed.

For the banks it examines itself (i.e., insured state-chartered nonmember banks and mutual savings banks), the FDIC may issue cease-and-desist orders against specific practices it deems improper, remove bank officers that engage in substantial violations of laws, regulations, or sound banking practices, and even levy civil monetary penalties. For federal supervision of other insured banks, it must rely on the Fed and the Office of the Comptroller of the Currency to take parallel enforcement actions. During the early 1980s, the number of such actions has trended upward with the number of problem banks.

Because the effects of formally shutting down an institution are effectively irreversible, requiring that an independent agency concur in advance with an insurer's decision to declare a bank insolvent has the benefit of protecting deposit-institution customers, managers, creditors, and stockholders against abusive uses of FDIC or FSLIC regulatory authority. However, given that injured parties retain the right to sue for damages ex post, this benefit should be weighed against the costs that systematically delaying the failure of moribund firms visits on the taxpayer. The benefits of requiring the FDIC and FSLIC to win the assent of other federal regulators merely to alter the level and composition of capital requirements or to update procedures for monitoring client institutions are even more questionable.

Insurer rights could be strengthened in many ways. By far the simplest approach would be to consolidate federal deposit-institution regulatory functions wholly, or at least primarily, in the federal deposit-insurance agencies. However, this approach would reduce the bureaucratic dominions of the Federal Reserve System and the Comptroller of the Currency and threaten job opportunities for identifiable groups of these agencies' employees. Maintaining that their supervisory functions are essential to their greater missions, each agency's leadership is prepared to lobby vigorously to retain them. Because the weight of the Fed's macroeconomic responsibilities give it extraordinary clout in Congress, the chances of transferring its regulatory powers to the FDIC are miniscule.

Treating the structural partition of federal supervisory authority as a given, Congress has been willing to entertain proposals to increase the authority of the federal insurance agencies to examine insured institutions, to reduce procedural delays in terminating insurance, and to impose further regulatory and civil sanctions on institutions whose managers engage in abusive practices. However, in the absence of a perceived legislative crisis, deposit institutions may be expected to lobby effectively to prevent applicable sanctions and statutory redefinitions of abusive practices from gaining much sweep.

Even without new powers, the FDIC and FSLIC should adopt policies that commit them more determinedly to protecting their economic interests. It should be noted that, not until economic pressure against their reserve funds became severe, did FDIC and FSLIC officials begin systematically to take administrative actions designed to foster uncertainty about the extent of their de facto commitment to rescue uninsured creditors.

The most important of these administrative actions was to develop a new technique for resolving failures that is known as the deposit transfer or modified payoff. In one variant of these transactions, the insurer sells only a failing firm's insured deposits to an acquiring institution and leases rather than sells the dead institution's premises and equipment to the acquirer. In several 1983-84 failures, the FDIC's approach was to sell the acquiring institution only the sum of the failed firm's insured deposits and its estimate of the percentage of uninsured deposits that the FDIC would recover in liquidating the firm's portfolio. If not overruled by the courts, this technique promises to make uninsured creditors take their lumps in liquidation without overly disrupting the financial lives of a failed institution's insured customers.

However, when the use of this technique helped to increase uninsured depositors' anxiety about the viability of Continental Illinois, it was at least temporarily abandoned. In the long run, I believe that it will prove regrettable that the essentially political advantages of preserving the accounting value of FDIC reserves persuaded the agency against using some variant of the modified-payoff technique to resolve the multibillion-dollar insolvency of Continental Illinois. Whatever the short-run benefits of shoring up the agency's insurance reserves and sharply arresting the spread of depositor pressure to other large banks, destabilizing precedents have been set by permitting an insurer to issue de jure guarantees of both the claims of Continental's uninsured creditors and the debt of its parent holding company. Paying uninsured creditors of the bank 98 cents on the dollar could have controlled direct contagion without imposing such large implicit funding burdens on the taxpayer.

The precedent set by the Continental Illinois bailout undermines the potential effectiveness of the FDIC's current proposal to raise capital requirements sharply for client banks, while permitting banks to raise the incremental funds by means of subordinated debt or debt sold to a parent holding company (Silverberg, 1985). To the extent that debtholders feel themselves to be in line for a bailout in the event the bank's ordinary equity is exhausted, they will not hold out for a risk premium high enough to bring risk-taking under control. Because the conjectural probability of bailouts increases with the size of the bank being financed, this approach would reinforce the de facto discrimination in the perfection of deposit-insurance guarantees available to large and small institutions.

A second category of administrative action has focused on reducing the size of the endgame play that an insolvent institution can make between successive examination dates. The proximate goal of this line of action is to limit CD brokers' ability to pyramid the $100,000 insurance coverage granted individual depositors to create large blocks of fully insured funds. In early 1984, the FDIC and FSLIC proposed to limit insurance coverage on the aggregate of funds placed in any single institution through any one broker to $100,000. They were forced to backtrack from this initial proposal both by lobbying pressure that CD brokers channeled through Congress and by the federal courts. A June 1984 ruling in U.S. district court, affirmed by the U.S. Court of Appeals in January 1985, upheld a legal challenge the brokerage industry filed against their action. Related proposals under active FDIC consideration include dropping its coverage of any deposits owned by financial institutions and eliminating various forms of trusteed accounts' rights to what has amounted to virtually unlimited coverage. Both proposals are aimed at closing loopholes through which a CD broker could almost costlessly circumvent FDIC and FSLIC efforts to control the proliferation of brokered funds in failing institutions.

On the issue of brokered deposits, the FDIC's and FSLIC's only victory so far has been to increase reporting frequencies for institutions that rely heavily on brokered deposits. Since August 1984, FDIC-insured banks have been required to file monthly reports and to be prepared to submit to sudden examination whenever five or more percent of their deposits come from CD brokers. This asymmetric data-gathering requirement underscores the inadequacy of the FDIC's and FSLIC's overall information systems. Insurers' information systems have notably lagged behind those operated by large well-managed commercial banks. As more deposit institutions adopt electronic record-keeping and as telecommunications systems improve, more frequent and more extensive readings of clients' electronic balance sheets become less burdensome all the time. With a more adequate information base, agency asset-liability committees (ALCOs) could be set up to manage each agency's aggregate exposure to interest-volatility, industry, and country risk.

3. Recalibration of Insurance Coverages

The economic value of a dollar of deposit insurance varies in two ways: (1) at a given institution, it varies with the type of account covered, and (2) for a given type of account, it varies with the riskiness of the portfolio policies followed at the institution that issues the deposits. As a complementary way of improving insurers' information flow, Congress should permit deposit insurers to alter their coverages and fee structure to generate information on an individual institution's own perception of the benefits it reaps from insuring different types of accounts in different ways. As we noted earlier, deposit insurers and uninsured creditors have less information about an institution's risk exposure than a deposit institution's managers have. By developing a wider-ranging structure of insurance coverages and associated premiums, managerial assessments of the value of different kinds of coverage could be extracted from their willingness and unwillingness to pay a set of carefully varied asking prices for specific coverages. Even more information could be gathered if clients were permitted to switch insurers in pursuit of what they regard as cheaper or more reliable coverages.

Managers' selection of coverages signals how risky they and their customers perceive a given institution to be. Low-risk institutions should operate most profitably with minimal coverages. Money-market mutual funds provide an instance of conservatively managed near-depository institutions that operate effectively without any insurance at all. On the other hand, high-risk institutions should be able to compete best when they obtain maximal coverages from one or more extremely reliable insurers. If the representative institution were to demand maximal coverages on all account types, we could infer that the price of each type of insurance is too low across the board and that risk-bearing is being subsidized industry-wide.

What is needed is a strategy for assembling information on which a reliable process of risk-rating could be based. While I prefer to leave detailed planning to insurance specialists, as a start, I would recommend three changes in contract provisions:

a. Lowering (perhaps gradually) the basic coverage per account to a level sufficient to protect the transactions and precautionary balances of most household customers. An upper limit of $10,000 is particularly attractive, inasmuch as this is the minimum denomination on U.S. Treasury bills which stand as a close substitute for large-denomination holdings of insured deposits. If such a limit is adopted, future values of the ceiling should simultaneously be indexed for inflation to make it more difficult for lobbying pressure to re-introduce the real value of maximum account coverage into the political arena. Congress needs to recognize that its decision to increase account coverage to $100,000 in 1980 was a serious mistake that it should strive to rectify as soon as possible. Fully insuring large-denomination deposits effectively permits banks to issue high-denomination federally guaranteed debt that in divisibility and liquidity is actually superior to ordinary Treasury securities.

b. Differentially pricing successive layers of optional supplementary coverages (offered, say, in $10,000 slices) and adjusting these prices in accordance with market principles. These coverages could be purchased either by institutions acting on behalf of holders of specific classes of deposit accounts or by individual depositors acting on their own. Market-based pricing would seek to cover the implicit and explicit costs of producing FDIC and FSLIC insurance services at the level of client demand served. The aptness of the prices charged could be tested by laying off some or all of these contracts in the market for reinsurance.

c. Introducing provisions for deductible and coinsurance elements into this supplementary coverage. In introducing these elements, authorities could investigate the effects of relating progressive declines in coverage directly to account size and inversely to an account's maturity.

A complementary action would be to impose cumulative lifetime limits on the collectability of an individual or institutional depositor's aggregate claims on the federal deposit-insurance agencies. Adopting cumulative ceilings would parallel the coverage patterns employed in underwriting major medical insurance, making it important for even fully insured depositors to "care" whether CD brokers transfer their funds into insolvent institutions.

Opponents emphasize that these adjustments would penalize large depositors and increase deposit-institution funding costs. The other side of this criticism is that the existing pattern of subsidies is anti-egalitarian welfare for large depositors who are wealthy enough to buy nominally risk-free debt in large denominations directly from the Treasury. Taxpayers as a whole would benefit from reducing the true cost to government entities of underwriting deposit-institution risk-taking.

4. Risk-Rated Explicit Premiums

Risk rating is the process of analyzing and pricing the risk exposure inherent in a particular insurance contract. Explicit insurance premiums are fees that clients pay in the coin of the realm. The major benefit from realigning deposit-insurance coverages would be to produce information that an insurer could use to develop a premium structure that would curtail its moral hazard. Risk-sensitive explicit pricing is needed to relegate *ex ante* implicit premiums on previously recognized forms of risk-taking to a lesser role.

Risk-rated explicit premiums need not consist entirely of *ex ante* payments. Such payments may include procedures for an *ex-post* settling up of gains and losses between an insured institution, its stockholders, and the insurer. To lessen the incentive for last-ditch gambles, *ex-post* settlement schemes could include provisions extending the limited liability of the stockholders of a failed institution or even of the stockholders of its parent holding company (as in the double or triple liability that used to apply to holders of a bank's stock) or to give the insurer the right to claim an appropriate share of any gains that a client reaps from forms of risk-taking that FDIC or FSLIC policy statements declare to have been abusive.

If a firm records the market value of every other time on its expanded balance sheet, including sources of value that current accounting principles designate as off-balance-sheet or unbookable items, the value of federal guarantee services to an individual firm can be calculated as a residual from the value that the stock market places on the equity of the firm. In principle, a firm's stock value, S, equals the market value of bookable and unbookable assets, A+A' minus the market value of bookable and unbookable nonequity liabilities, L+L'. If every other off-balance-sheet source of value is accounted for, the value of a firm's explicit and conjectural federal guarantees net of discounted future premiums, F_{CG}, may be calculated as:

$$F_{CG} = S-(A+A')+(L+L').$$

The annual cost of providing this guarantee, $C(F_{CG})$, may be defined as the interest cost of supporting the average value the guarantee has during the year, $i_t\bar{F}_{CG}(t)$, plus the change in the market value that occurs from yearend to yearend:

$$C(F_{CG}) - i_t\bar{F}_{CG}(t) + F_{CG}(t)-F_{CG}(t-1).$$

If the liability of stockholders in every financial institution that enjoys a conjectural guarantee were extended to two (or more) times the par value of their stockholdings, as the liability of stockholders in national banks was until 1959, quarterly or annual charges designed to recover this cost could be levied on an ex post basis. Moreover, such a scheme could price away the advantages of the differentially stronger guarantee received by banks that the market currently perceives to be too large for regulators to liquidate.

The many opponents of risk-rating emphasize that setting ex ante premiums or designing an equitable scheme for ex post settling up is a difficult task, requiring a considerably larger information base than is collected today (Horvitz, 1983). However difficult it may be for isolated teams of regulators, it is not beyond the capability of the modern methods of contingent-contract writing and information processing. As Pyle (1984) points out, corporate bond markets undertake similar kinds of risk assessments every trading day. Nor are these risk assessments demonstrably more difficult than others that private insurance companies perform. Modern insurance companies price many exotic forms of risk, including damages visited on insured parties by computer crime, divorce, cancer, tax audits, and space debris. No matter how great the practical difficulties of rating a deposit institution's risk exposure, the current approach is defective in principle. To maintain permanently an unfunded system that insures risk borne by deposit institutions at a price that lies far below the return offered in capital markets for risk-bearing services is to establish a kind of Ponzi scheme. The longer such a system remains in place, the more severely it will be tested. As time passes, individual institutions become more fully aware of opportunities for exploiting the situation and develop less compunction about seeking to take advantage of them.

Although ex post settlement and extended stockholder liability would be administratively easier than ex ante pricing, these concepts frighten many deposit-institution managers. They point out that a return to double or triple liability on deposit-institution stock would raise the cost of raising private equity capital. They also express concern that FDIC and FSLIC policy statements could degenerate into devices for bringing political influence to bear on institutions' lending priorities. To make sure that these policy statements serve only the purpose of ruling out such demonstrably dangerous activities as betting an institution's very survival on the future course of interest rates or on the success of particular types of investment projects, it would be useful to assign the task of defining abuses to self-regulatory organization: a deposit-insurance standards board made up of leading practitioners and industry analysts.

What makes risk-sensitive pricing such a hard task is the essential fluidity of opportunities to take risk in financial markets. An institution's adaptive efficiency may be defined as its organizational resourcefulness, which reflects its managers' capacity to think deeply about simple problems and the flexibility they show in adjusting their administrative structure and procedures to cope with sudden or rapid change. To keep risk ratings and insurance premiums current requires considerable adaptive efficiency. For this reason, it seems dangerous to assign the function wholly to government officials. This leads to the fifth option in my program.

5. Meaningful Opportunities for Mixed Private and Governmental Competition in Deposit Insurance

To enhance incentives for deposit-insurance agencies to maximize their adaptive efficiency, it is necessary to provide opportunities for the FDIC and FSLIC to compete with each other (Benston, 1983) and for private firms to issue or to reinsure at least some layers of supplementary deposit-insurance coverage. To neutralize political pressure for low prices and uneconomic coverages, authorities must invite into the contract-design and contract-pricing process decisionmakers whose only stakes are economic — parties whose jobs and firms can and will be wiped out if they issue contracts which fail to make it a client's own best interest to keep its risk exposure within prudent bounds.

Private firms may be counted upon to enter any business in which they can anticipate earning a fair return. As if to demonstrate this proposition, during the 1980s private insurance companies have begun to nibble eagerly around the edges of the deposit-insurance market. The biggest growth has been in guaranteeing cash flows to bondholders. In markets for deposit substitutes, the insurance industry focuses principally on offering supplementary guarantees for individual accountholders that, beginning where federal guarantees stop, greatly extend the size of the balance covered. Such insurance is particularly attractive to nondepository institutions such as brokerage firms and insurance companies seeking to market nondepository accounts designed to function much like deposit balances. One notable example is Aetna's provision of supplementary guarantees that operate on top of the Securities Investor Protection Corporation's $500,000 basic guarantee to lift coverage for any holder of a Merrill Lynch's cash-management account to $10 million. Also, two money-market funds have secured coverage for their customers: one from St. Paul Money Fund Inc. in Minnesota and the other from the Travelers Corporation of Hartford. In a more exotic vein, Cigna Corporation temporarily issued Citicorp $900 million worth of insurance against the risk of currency inconvertibility in five countries. The policies covered the contingency that scheduled repayments by debtors in Argentina, Brazil, Mexico, Venezuela, and the Philippines would fail to be remitted because their governments might decide against permiting local currency to be converted into dollars. The contracts included a deductible equal to 25 percent of Citicorp's exposure in each country and a six-month delay before any unremitted debt proceeds may be collected. Affirming the interest of other segments of the industry, Cigna announced that it had reinsured over 95 percent of the coverage.

While private insurance of deposit-institution risks should continue to grow, as long as Congress requires the deposit-insurance agencies to maintain unrealistically low explicit premiums, the core of federal insurers' business will remain insulated from the discipline of private competition. It is this insulation that enables agency managers to emphasize political and bureaucratic objectives over their need to adapt economically to rapid change.

6. Statutory Constraints on FDIC and Federal Reserve Authority to Rescue Insolvent Large Institutions

Although deposit-institution regulators profess a sincere belief in the theoretical benefits of market discipline, practical circumstances inevitably make them reluctant to liquidate a large institution. Given the short terms of office that financial regulators enjoy, it makes little sense for them to take an appreciable chance that a spillover of financial pressure will damage other institutions or undermine public confidence in depository institutions as a whole. Why should an agency's leadership risk ruining their own careers when they can reliably truncate further damage with a readily obtained injection of federal funds and federal guarantees that serve to rescue a failing institution and its creditors from the need to sustain uncomfortable levels of losses. Confirming this analysis, Comptroller of the Currency Todd Conover went so far as to assert that in September 1984 the Federal government wouldn't allow any of the nations 11 largest banks to be liquidated.

To hear the sirens' song without being lured to his death, Ulysses had to arrange to have himself strapped to the mast of his ship. Similarly, the reliable way to lessen the probability that the Fed and federal deposit insurers will routinely bail out large insolvent deposit institutions and (potentially) private deposit-insurance companies is to place statutory limits on their ability to respond to the political and bureaucratic siren call of short-sighted opportunities for using federal resources to rescue firms that are insolvent de facto.

Although any proposal to limit the discretion of deposit-institution regulators is bound to be controversial, the potential for private loss must be strengthened if implicit federal guarantees are to be made imperfect enough for market discipline to operate properly. The first and most important step would be to require that federal deposit-insurance agencies (like private deposit insurers) leave the short-term responsibility for stabilizing the financial system wholly in the hands of the Federal Reserve, acting in its capacity as lender of last resort. Deposit insurance will not be properly priced as long as bailout responsibilities compromise the economic function of deposit-insurance reserves. Responsibility for stabilizing financial markets should not be crammed into the mission statement of federal deposit-insurance agencies. Second, even the Federal Reserve's capacity for bailing out insolvent institutions needs to be constrained. Except in the event of a bona fide crisis — as defined by the condition that a given percentage (say, at least five percent) of aggregate deposit-institution assets in a region has been involved in de jure failures within the last 12 or 18 months —the Fed should not be allowed to lend funds to an institution whose capital net of the federal guarantee is negative in market vaue. This would increase the probability that one or two large institutions could fail de jure, but leave the Fed free both to assist a troubled firm to arrange financing from private sources and to arrest a developing run on the system as a whole.

What this reform would not do is to let authorities repeatedly use the mere possibility of a systemic run as a justification for bailing out individual institutions as a matter of course. The policy of routinely bailing out financially devastated institutions imposes enormous unaccounted expense and unrecognized liabilities onto the deposit-insurance agencies and through them onto taxpayers and conservatively managed competitors who knowingly or unknowingly backstop the limited insurance reserves these agencies hold. As long as large deposit institutions and their creditors may count on drawing federal subsidies to extract themselves from what would otherwise be do-or-die situations, the potentially salutary effects of market discipline have little opportunity to make themselves felt.

The Political Dilemma of Reform

Conceived in 1933 as a device for protecting small depositors and bolstering public confidence in financial institutions, the subsequent interplay of political forces has assigned federal deposit insurance a far-broader bureaucratic mission. It functions today as a system for implicitly guaranteeing the capacity of the deposit-institution system to make good on all but a small percentage of its outstanding debt. These implicit guarantees purchase the appearance of stability at the cost of undermining the fear of failure that ordinarily leads an institution's creditors to impose market discipline on its risk-taking activity. They also shift the burden for financing unfavorable outcomes to taxpayers and conservatively managed financial institutions. The result has been a spate of de facto or market-value insolvencies among insured institutions that the U.S. would recognize as a national disaster if politicians had to present the bill for underwriting these insolvencies to the body politic.

To reduce the underwriting bill and to restore market discipline, it is necessary to make deposit-institution creditors fear failure again. To be meaningful, deposit-insurance reform must reduce the flow of subsidies to deposit institutions. It must endeavor to shift the burden of underwriting catastrophic financial risks from the general taxpayer back toward insured institutions and their creditors. We may count upon political forces to see that Congress develops a set

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of rules that ease the burdens of transition. But before it can do that, it must agree on the nature of the system it wants to establish for the long run. A better deposit-insurance system must be one that increases the cost to insured institutions of following subsidy-exploiting strategies of funding, lending, and product-line expansion that have seemed so very profitable in the past.

Every one of this paper's six varieties of reform promises to complicate the jobs of deposit-insurance bureaucrats and to hurt deposit-institution stockholders managers, and large accountholders to some degree. Because they see the need to restore financial stability, most of these parties support deposit-insurance reform in principle. But to keep their own oxen from being gored, individually they support and oppose different combinations of the six reforms. Industry trade associations must be expected to lobby vigorously against any subset of the six proposals that in the judgment of their membership threatens to hit the firms they represent with disproportionate force. This leaves every one of the six proposals with important enemies and with virtually no important friends.

Each trade association's greatest fears are that its sector of the deposit institution industry will suffer greatly during the transition to a fairer and sounder system and end up regulated more burdensomely than before. Each wants to minimize the extent to which deposit insurance reform could reduce the value of its particular type of depository firm. Inasmuch as each association's membership acknowledges the nation's need for deposit insurance reform, their active resistance to anything but token reform puts them in the position of a banker who decided to consult a psychiatrist about a problem his brother had been causing him and his family. The problem was that his brother had come to believe he was a chicken. His incessant cackling was upsetting everyone in the household and embarrassing them in front of their friends. The psychiatrist assured the banker that he was a leading expert on fixations of this sort and could cure his brother completely in no more than six sessions of therapy. But rather than being pleased by this news, the banker became more agitated than ever. "Hold on," he said. "We are only complaining about the cackling. No one in the family wants to give up the eggs he lays."

Deposit institutions are able to harvest eggs from the deposit insurance system only because their deepest layers of risk-bearing are being unintentionally subsidized. As long as this subsidy continues, incentives exist for managers to bet their firm on the future course of interest rates and on the prosperity of specific projects and geographic areas. Some of these bets must lose and, for the losers, nationalization looms as an increasingly likely possibility.

Perhaps the greatest irony of financial regulatory reform in the United States is that a necessary condition for its occurrence -- a spectacular scandal or financial crisis -- is virtually a sufficient condition for a program of reform that pays too little attention to long-term problems. Although reform seldom occurs outside an environment of perceived crisis, a crisis atmosphere favors short-sighted solutions. In the midst of a crisis regulators and politicians pay far more attention to the system's immediate difficulties than to its long-run needs. A sympathetic analogy is to consider how hard it would be for a football coach to prepare his team to play its season on dry fields, when fate dictates that their training camp must be held on a quagmire.

Today two immediate difficulties frame the problems that regulators see. First, because authorities have proved reluctant to declare de jure failures in the past, the market value of the nonequity liabilities of most deposit institutions exceeds the market value of the assets that they may recognize under generally accepted accounting principles. Second, because of this, the staffs and explicit insurance reserves of the deposit insurance agencies are overwhelmed. The inadequacy of explicit agency reserves leads agency managers to resort to selling regulatory exemptions and to emphasize noncash forms of assistance such as income-maintenance agreements and ownership positions. At the same time staff limitations permit them to discipline only a few of the many institutions that engage in excessive risk-taking. These constraints make it hard for the average number of de jure failures to exceed two a week, while the pricing of deposit insurance continues to lead insolvent deposit institution managers to pursue a go-for-broke strategy.

It is not necessary for Congress to incorporate all of this paper's six options into the new-model deposit insurance system. Nor is it necessary that the options finally chosen be installed all at once. Although the complete package probably would produce the best results, adopting any subset of the six options would result in a system that in future years would operate with greater safety, reliability, and comfort. Of course, just how safe, reliable, and comfortable a ride the nation would ultimately enjoy depends also on the macroeconomic policies that the government follows. If Congress could bring government spending under long-run restraint, monetary policy would not have to push interest rates over so wide a cycle. Reducing the volatility of interest rates would relieve the car's drivers of the need to take it over quite so dangerous a set of roads.

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Chairman St Germain. Now we will hear from James Sexton, commissioner, Texas Department of Banking.

We will put your entire statement in the record, Mr. Sexton. You may proceed.

STATEMENT OF JAMES L. SEXTON, COMMISSIONER, TEXAS DEPARTMENT OF BANKING

Mr. Sexton. Thank you, Mr. Chairman.

I have been at the Texas Banking Department for 2 years. Prior to returning to Texas, I served in various positions with the Federal Deposit Insurance Corporation, the last being Director of Bank Supervision.

Having long admired the strengths of the FDIC and the job it does for the banking system and for the public, but sharing a concern that it is doing its job perhaps too well, I am especially appreciative of this opportunity to testify today concerning deposit insurance issues.

The notion of market discipline seeks to address the question: How do we do a better job in keeping the public's money out of the hands of those who are wasting it?

Two general types of solutions are available: one, add massive numbers of regulators to monitor financial institutions, or, two, enlist the help of the public in providing discipline.

Choosing the latter because it is more effective and efficient, we must immediately exclude the insured depositor, whose indifference is well documented, probably well justified, and totally consistent with what the Banking Act of 1933 sought to accomplish. It is believed, however, the uninsured depositor has the sort of vulnerability that perhaps can be used to advantage in bringing market discipline to bear.

The so-called modified payoff apparently is an excellent device in this regard. It facilitates loss sharing with uninsured creditors while avoiding an unacceptable degree of local economic shock.

With the development of the modified payoff technology, the possibility of a payoff of a large institution gained credibility it never before possessed. But probably not enough.

It is widely perceived that if a large institution were to become significantly insolvent, the up-front advance conceivably could fall short of the amount needed by uninsured customers to meet payrolls, make businesses run, et cetera, and could result in an unacceptable degree of economic disruption.

The salvation of this concept lies in having the uninsured creditors react well in advance to the approaching danger by placing funding pressure on the bank, forcing it to right its ways. The idea, after all, is deterrence, not punishment.

But would the public know enough about financial institutions to take the correct action? Certainly not yet—perhaps never.

The FFIEC has improved the bank call report substantially and it has created an excellent and publicly available uniform bank performance report. Those are good steps, but much remains to be done before the outsider will be enabled to see clearly the soul of the bank with which he or she does business and is able to make an intelligent decision about that bank.

Pressing forward on this point, the FDIC has decided to disclose formal enforcement actions. This is a good source of disclosure provided that it is applied uniformly to all financial institutions in a way that the public can really understand and react to.

If we were able to properly address the open questions on risk sharing mechanisms, and those surrounding the inseparable issue of disclosure, we are still faced with the threshold fallacy in the depositor discipline approach. It is a fact that many banks and many thrifts are impervious to depositor discipline—they have no, or at most negligible, uninsured deposits. In many cases, depositor discipline and disclosure would have no effect, aside from perhaps some social embarrassment to the executive officer and some overtime for those regulators who answer questions about Federal deposit insurance.

At best, the strategy comprising general creditor risk sharing and disclosure does not stop the practice we would like to have cease—it merely inhibits the use of uninsured funds for unsound purposes.

A superior proposal relates to enhanced capital including subordinated debt. The FDIC has mentioned a gradual increase of capital to 9-percent of assets in one of its proposals. With the use of subordinated debt, the bank would indeed be forced to subject itself to judgment by a market that we might properly consider sophisticated.

The subordinated debt would not only discipline bank management, incidentally, it would protect depositors as well. One prominent complaint against the proposal has been the presumed lack of a market for the debt of smaller, lesser-known banks.

For the proposal to succeed, that market would have to be created; by most accounts it does not presently exist. Once again, there emerges a need for uniformity among banks and thrifts.

With these caveats, the proposal to impose discipline through enhanced capital is a sound one. The formation of a subordinated debt market has a much better chance of affording sophisticated analysis and a proper meting out of discipline than does the use of large depositors for that purpose, the latter sometimes being referred to as sophisticated, but leaving many clues that indeed that hardly is the case.

And, of course, the subordinated debt holder would be locked in for the intermediate period and would not be free to cut and run when rumor or news hits the streets. He accordingly is likely to be a more exacting analyst, imposing better discipline before the fact, rather than being an instant executioner when the trouble actually arises.

Risk-related Federal deposit insurance assessments, while attractive, perhaps sounds more revolutionary than it really is. Traditional insurance concepts accept the level of risk as a hard fact, and vary the premium to reflect that risk. Risk is not an unalterable fact in banking. The Congress has given the regulators the statutory wherewithal to confine financial institution risk within a bank that we call safe and sound banking.

If a certain practice has a casual relationship to problem bank status or bank failure, that practice should be stopped, not used as a basis for increasing the insurance premiums. An example is the level of capital funds. If capital is low, it should be replaced, the bank should lose its deposit insurance, the bank should be prohibited from accepting additional risk assets, or some combination of these.

A valid criterion for imposing added deposit insurance assessments is the level of adversely classified assets. As long as the level of adversely classified assets is covered by the bank's capital, that is a regulatory matter. To the extent that adversely classified assets encroach on creditors' funds, that becomes a financial matter as well, and FDIC should be enabled to collect a risk premium equal to whatever amount the market might require, in addition to interest already received, to carry assets of that nature.

If market discipline were to take the form of enhanced capital providing for greater depositor protection, the idea of 100 percent Federal deposit insurance becomes viable and it becomes possible to eliminate the last vestige of the big bank advantage in the deposit insurance program.

We also would eliminate a parasite from the intermediation process by permitting depositors of all sizes to deal directly with the bank rather than through middle-man deposit brokers. Why indeed should the heavily-regulated banking industry be denied 100-percent deposit insurance when deposit brokers having no mandatory investment standards are, for all intents and purposes, insured 100 percent? These points all suggest that 100-percent deposit insurance is a good alternative, if market discipline is imposed through enhanced capital and certainly if, as recent court cases have suggested, deposit brokers cannot be eliminated from the depository process.

A program of 100-percent deposit insurance creates clear potential for abuse that would have to be dealt with in some fashion. To minimize that potential financial institutions should be prohibited from paying deposit interest at a rate materially in excess of an index amount published by each Federal Reserve Bank district bank each week or month. The Congress has taken the important step of allowing financial institutions to pay market rates on their obligations. A program of containment designed to curtail the dangerous practices of outliers in the thrift and banking industries would not be a step backwards in my estimation; rather, it would be an absolutely appropriate response to the frequent abuse the deposit insurance funds have suffered since the advent of deregulation.

The merger of the two major Federal insurance funds could be beneficial if accomplished as part of a series of steps designed to have all insured financial institutions possess the strength necessary to stand on their own and the ability and responsibility to answer for their own mistakes rather than having the insuring funds and perhaps ultimately the taxpayer do so.

If a merger of the funds were to be accompanied by aggressive measures to establish capital and accounting parity among the insured entities, it would be marginally worth the effort and the risk. Otherwise, a merger would be an empty exercise that would result in an immediate and serious weakening of the Federal Deposit Insurance Fund.

To me, 100 bank failures in a single year is not acceptable. They are disruptive, they are costly to the insurance funds, and they are costly to uninsured creditors, as well as stockholders. I do not believe, however, that regulation works well alone. Market discipline is needed. The business of banking surely is sufficiently important that the scrutiny of two sets of eyes is not only desirable, but utterly necessary.

Again, thank you for the opportunity to testify concerning these important matters.

[The prepared statement of Mr. Sexton follows:]

Commissioner James L. Sexton

Texas Department of Banking

Testimony Before the U.S. House of Representatives Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs

Ninety-ninth Congress
Washington, D.C.

September 18, 1985

I. Introduction

Mr. Chairman, my name is James L. Sexton. My present position, which I have held for two years, is Banking Commissioner of Texas. Prior to returning to Texas, I served in various positions with the Federal Deposit Insurance Corporation, the last being Director of Bank Supervision.

Having long admired the strengths of the FDIC and the job it does for the banking system and for the public, but sharing a concern that it is doing its job perhaps too well, I am especially appreciative of this opportunity to testify today concerning deposit insurance issues.

II. Bank Management Problems

Deposit interest rate deregulation was both necessary and desirable; however, the confluence of that event with the significant economic developments of the last four years has challenged our financial services system, and with a penetrating view unparalleled in the last fifty years, has identified the poorly-operated banks. The poor managers, accordingly, are being set apart from their peers, in whose ranks they have existed quietly and securely for many years. But at the same time, it has never been more clear that being a poor operator does not noticeably affect the funding of one's financial institution. In our system of privately-owned financial institutions, there have always been cases of using depositors' funds in speculative, unsafe, unproductive, even dishonest ways. In 1985, however, the problem is exacerbated by the high $100,000 deposit insurance limit, the new ability to pay any rate at all for funds, the deposit brokers that make their living leveraging the deposit insurance funds, and the high degree of apathy on the part of depositors, especially insured depositors.

III. Market Discipline

The question then arises -- How do we keep the public's money out of the hands of those that in a real and in a social sense are wasting or mismanaging it? The U. S. taxpayer expects his or her government to be prudent in the expenditure of tax dollars, and there is an endless array of safeguards to insure against undue leakage in that process; yet anyone that has, or with minimal effort obtains, a financial institution charter, has a license to do as he or she pleases with the same money, at least until caught.

This comparison, of course, forgets that the insurance funds do not operate with tax dollars. Observing the growing burden on the insurance funds and recalling the resolution of both Houses of Congress in 1982 to support the insurance funds with the full faith and credit of the U. S. Government, however, one must believe that this line of reasoning is not too far-fetched.

If we accept the notion that the numbers of problem banks and bank failures arise from inadequate motivation to pursue sound banking practices, then two general types of solutions are available: (1) add massive numbers of regulators to monitor financial institutions, or (2) enlist the help of the public in providing its own very effective and sudden brand of discipline.

Choosing the latter because it is more effective and efficient, we must immediately exclude the insured depositor, whose indifference is well-documented, probably well-justified, and totally consistent with what the Banking Act of 1933 sought to accomplish. The uninsured depositor, however, has the sort of vulnerability that perhaps can be used to advantage in bringing market discipline to bear.

A. The Modified Pay-off

The so-called modified pay-off, which places a pro rata proportion of the loss in an insolvent bank on the uninsured depositor, while cushioning the blow by making an up-front advance in the estimated amount of the ultimate dollar receivership value, apparently is an excellent device in this regard. It facilitates loss sharing with uninsured creditors while avoiding an unacceptable degree of local economic shock. With the development of the modified pay-off technology, the possibility of a pay-off of a large institution gained credibility it never before possessed. But probably not enough. If a large institution were to become insolvent by virtue of some spontaneous shock, the up-front advance conceivably could fall short of the amount needed by uninsured customers to meet payrolls, make businesses run, etc., and could result in an unacceptable degree of economic disruption. Since the government would be exposed to whatever shortfall ultimately existed between the up-front advance and the collection of the failed company's assets, the advance would have to be made on a conservative basis, adding further to the shortfall and to the immediate economic disruption.

The salvation of this concept lies in having the uninsured creditors react well in advance to the approaching danger by placing funding pressure on the bank, forcing it to right its ways. The idea, after all, is deterrence, not punishment. If the modified pay-off became the only statutory alternative, would the public know enough about financial institutions to take the correct action? Certainly not yet - perhaps never. The Federal Financial Institutions Examination Council has improved the bank call report substantially, and it has created an excellent and publicly available uniform bank performance report. Those are good initial steps, but much remains to be done before the outsider will be enabled to see clearly the soul of the bank with which he or she does business and is able to make an intelligent decision as to whether that bank is a safe place to keep his or her money.

B. Disclosure

Pressing forward on this point, the FDIC has decided to disclose formal enforcement actions. As finally passed, the related FDIC rule provides much more than just the name of the entity being cited; it gives the public a synopsis of the problem within the bank. This could be a good source of disclosure, provided that a major deficiency is addressed; that is, the FDIC disclosure falls unevenly on regulated institutions. It is conceivable, even probable, that depositors occasionally will be run out of a bad state nonmember bank, which is subject to disclosure of administrative action, into a worse bank or thrift where disclosure is not enforced. Another perhaps lesser deficiency is the fact that not all administrative actions are equally germane. Some address extremely serious, perhaps terminal problems; others more properly will seek to address certain problems in their embryonic state. Moreover, in various cases, the degree of management culpability compared to the workings of external factors varies widely. Whether the public will bother to try to understand these differences, or will simply opt for the easier course of changing banks, is certainly open to question.

If we were able to properly address the open questions on risk sharing mechanisms, such as the modified pay-off, and those surrounding the inseparable issue of disclosure, we are still faced with the threshold fallacy in the depositor discipline approach. It is a fact that many banks and many thrifts are impervious to depositor discipline -- they have no, or at most negligible, uninsured deposits. In many egregious cases, depositor discipline and disclosure would have no effect, aside from perhaps some social embarrassment to the executive officer and some overtime for those regulators who answer questions about deposit insurance.

At best, the strategy comprising general creditor risk sharing and disclosure does not stop the practice we would like to have cease -- it merely inhibits the use of uninsured funds for unsound purposes. Accordingly, if the technology necessary to implement this strategy were fully developed, the system would take on a definite small bank or thrift bias, just as surely as the present system possesses a large bank bias.

C. Enhanced Capital and Subordinated Debt

A superior proposal relates to enhanced capital including subordinated debt. The FDIC has mentioned a gradual increase of capital to 9% of assets in one of its proposals. With the use of subordinated debt the bank would indeed be forced to subject itself to judgment by a market that we might properly consider sophisticated. If the debt matured serially, for instance, one-third every two years, the bank would have to come to the market with sufficient frequency that bank management would have to be continually mindful of the stern demands of the market. The subordinated debt would not only discipline bank management, incidentally, it would protect depositors as well. One prominent complaint against the proposal has been the presumed lack of a market for the debt of smaller, lesser-known banks, notwithstanding that the debt of many of the smaller banks actually should be more acceptable to the market than that of certain larger banks if credit quality is the sole criterion and size and its mythical virtues are disregarded. One might well presume that if the demand exists, a market would open up to supply that need. For the proposal to succeed, that market would have to be created; by most accounts it does not presently exist.

Once again, there emerges a need for uniformity. If banks are expected to meet the standard, the same must be required of thrifts unless they are to be reregulated and placed out of direct competition with banks. The disparity in leverage is already creating competitive imbalance between banks and thrifts. In Houston, on an average day, savings and loan institutions will pay from 50 to 125 basis points more for deposits than banks will pay, depending upon the category of deposit. If the higher bank capital ratios were imposed unilaterally on banks, with no relief of any kind from the competitive pressures they now face, the program would be most unfair and bank equities would become much less attractive.

With these caveats, the proposal to impose discipline through enhanced capital is a sound one. The formation of a subordinated debt market has a much better chance of affording sophisticated analysis and a proper meting out of discipline than does the use of large depositors for that purpose, the latter sometimes being referred to as sophisticated, but leaving many clues that indeed that hardly is the case. And, of course, the subordinated debt holder would be locked in for the intermediate period and would not be free to cut and run when rumor or news hits the streets. He accordingly is likely to be a more exacting analyst, imposing better discipline before the fact, rather than being an instant executioner when the trouble actually arises.

It should be noted that the FDIC proposal for enhanced capital works best if the base capital figure, before enhancement, excludes the bad debt reserve and is based on a calculation that takes risk, not total assets, into account. If a raw capital and reserves-to-assets computation is used, a good bank ends up overcapitalized, while a lesser bank may be only marginally or perhaps deficiently capitalized, although both have the same capital and reserves-to-assets ratio. That treatment would seem to reward precisely the wrong institution.

D. Risk-related Capital Requirements

Risk-related capital requirements constitute a very tangible discipline. That concept, of course, is not new at all -- regulators use it every day to determine what level of capital should be required for individual banks. The current minimum capital standards of each federal agency are couched in terms that make clear the fact that those minimum numbers of 5.5% and 6.0% apply only to well-managed, well-diversified, clean institutions. The negative implication is that the institution not meeting that description will need additional capital to meet the regulators' perception of risk. What has not been done with the risk approach to capital adequacy is that it has not been precisely articulated. Doing so would be a feat of manifold difficulty, and undoubtedly would lend itself to loophole exploitation, but a capital standard based on even general risk asset categories would be superior to the simplistic capital-to-assets ratio.

Many financial institutions have gone off the balance sheet with their risks to exploit the absence of regulatory capital standards for off-balance sheet obligations. It is imperative that that omission be remedied by the regulators.

E. Risk-related Deposit Insurance Premiums

Risk-related federal deposit insurance assessments likewise sounds more revolutionary than it really is. Traditional insurance concepts accept the level of risk as a hard fact, and vary the premium to reflect that risk. Risk is not an unalterable fact in banking. The Congress has given the regulators the statutory wherewithal to confine financial institution risk within a band that we call safe and sound banking. For various reasons, including the fact that regulators, like those they regulate, cannot see around economic corners, there is occasional slippage in that process. But regulators should have few complaints about the authority granted them under the law to regulate the banking system.

If a certain practice has a causal relationship to problem bank status or bank failure, that practice should be stopped, not used as a basis for increasing the insurance premiums. An example is the level of capital funds. If capital is low, it should be replaced, the bank should lose its deposit insurance, the bank should be prohibited from accepting additional risk assets, or some combination of these.

The only valid criterion for imposing added deposit insurance assessments is the level of adversely classified assets. As long as the level of adversely classified assets is covered by the bank's capital, that is a regulatory matter. To the extent that adversely classified assets encroach on creditors' funds, that becomes a financial matter as well, and FDIC should be enabled to collect a risk premium of perhaps 4% to 5% of the exposed amount, or whatever amount the market might require, in addition to interest already received, to carry assets of that nature.

That the high level of insurance afforded each depositor has contributed measurably to the misuse of deposit insurance is fairly apparent. It has even been suggested that we roll back the clock and reestablish the limit at $40,000. That might be a bit helpful; however, the major result logically would be the increased involvement of deposit brokers in the intermediation process.

Breaking deposits into $40,000 parcels rather than $100,000 would involve nothing more than a programming change. And then we would come back to the questions of the efficacy of disclosure and whether depositors would accept having uninsured deposits or simply open more accounts at more financial institutions. Having said all this, I doubt that this idea is sufficiently feasible as to benefits vs. public reaction to warrant serious consideration.

F. 100% Deposit Insurance and Brokered Deposits

If market discipline were to take the form of enhanced capital providing for greater depositor protection, the idea of 100% federal deposit insurance becomes viable and it becomes possible to eliminate the last vestige of the big bank advantage in the deposit insurance program. We also would eliminate a parasite from the intermediation process by permitting depositors of all sizes to deal directly with the bank rather than through middle-man deposit brokers. Why indeed should the heavily-regulated banking industry be denied 100% deposit insurance when deposit brokers having no mandatory investment standards at all are, for all intents and purposes, insured 100%? These points all suggest that 100% deposit insurance is a good alternative, *if* market discipline is imposed through enhanced capital and certainly *if*, as recent court cases have suggested, deposit brokers cannot be eliminated from the depository process.

A program of 100% deposit insurance creates clear potential for abuse that would have to be dealt with in some fashion. To minimize that potential, deposits accepted or advertised for at rates more than 50 basis points greater than an index amount published by each Federal Reserve Bank district bank each week or month should be prohibited. The Congress has taken the important step of allowing financial institutions to pay market rates on their obligations. A program of containment designed to curtail the dangerous practices of outliers in the thrift and banking industries would not be a step backwards in my estimation; rather, it would be an exercise in common sense and an absolutely appropriate response to the frequent abuse the deposit insurance funds have suffered since the advent of deregulation. Also, the FDIC and FSLIC should be given the ability to challenge the good faith of direct or indirect insider deposits exceeding $100,000 found in a failed bank.

G. Private and Federal Deposit Insurance Funds

Underpinning all the discussion about deposit insurance is the integrity of the insurance funds. The recent lack of performance of certain private insurance funds demonstrates clearly enough that ostensible actuarial soundness and comparability with or superiority to the federal deposit insurance funds is not enough. The Federal Deposit Insurance Fund comprises a package of features - effective supervision, a record of high performance in bad times as well as good, and what much of the public perceives as a tap root into the vaults of the U. S. Treasury - that is impossible to duplicate at the private level. Wholesale banking tragedies cannot be isolated in their impact, and the unsettling reverberations of the failure of a private deposit insurance system are felt well beyond the directly-affected area. Whether preservation of competition in the deposit insurance business is worth the widespread confidence shock and the direct personal financial tragedies caused by the occasional failure of private funds is very doubtful.

The merger of the two major federal insurance funds could be beneficial if accomplished as a part of a series of steps designed to have all insured financial institutions possess the strength necessary to stand on their own and the ability and responsibility to answer for their own mistakes rather than having the insuring funds and perhaps ultimately the taxpayer do so. When a federal regulator is compelled to warn members of a supposedly private sector industry that they are paying too much for deposits, something very important is obviously awry, and an urgent message is sent that a privately-owned thrift system that has served this country so well for so long is taking important steps in forfeiting its right to independence.

Nowhere is this fact better understood than in the banking industry, where the merger of the funds is widely opposed. The foundation of the right of the banking industry to be independent exists in a combination of its strong deposit insurance fund which has permitted private banking to absorb its casualties while actually continuing to grow, and its strong capital base. If a merger of the funds were to be accompanied by aggressive measures to establish capital and accounting parity among the insured entities, it would be marginally worth the effort and the risk. Otherwise, a merger would be an empty exercise that would result in an immediate and serious weakening of the Federal Deposit Insurance Fund. Were the Federal Home Loan Bank Board to continue its current steps toward some degree of recapitalization of the Federal Savings and Loan Insurance Fund prior to such a merger, the likelihood that the combined fund could continue indefinitely to meet its obligations obviously would be enhanced proportionately.

IV. Increased Regulatory Presence

There is something to be said for not preoccupying ourselves with market discipline, adding a significant new number of regulators and simply doing the job that regulators are empowered to do. In my opinion, the number of regulators and the level of regulatory activity is somewhat inadequate at this point. Deregulation has sent financial institutions looking for loans and other investments to offset the cost of funds. Since there is little inflation with which to bail out bad decisions by bankers or the customers they finance, it is not a good time for the kind of aggressive loan marketing effort presently occurring. Savers, at long last, are getting the type of real rates they deserve, and the generation of "slam-dunk" borrowing transactions, accomplished not through any particular personal expertise, but through using inflation against funds suppliers, thankfully is past for now. But all this adds up to more risk as interest margins are more subject to bleeding away through the bad debt reserve. And these types of risk are not very transparent to the public or to regulators through published reports until a regulator has identified the problem and the bad debt reserve is adjusted accordingly.

To me, 100 bank failures in a single year is not acceptable. They are disruptive, they are costly to the insurance funds, and they are costly to uninsured creditors, as well as stockholders. I do not believe, however, that regulation works well alone. Market discipline is needed. The business of banking surely is sufficiently important that the scrutiny of two sets of eyes is not only desirable, but utterly necessary.

V. Market Value Accounting

Generally Accepted Accounting Principles ("GAAP") is the official language of the business world. We prepare financial statements and we read financial statements using that language on the premise that the fiscal truth is being thereby communicated. One instance in which GAAP is deficient in conveying the real truth is in the presentation of balance sheet values on the basis of historical cost, as opposed to market value. Market value accounting would be a superior methodology insofar as balance sheet presentation is concerned, and it would discourage such practices as selling appreciated assets and retaining depreciated assets, a fairly common practice among financial institutions seeking to "manage" their earnings in an ethically permissible way.

Another objection to historical cost accounting is its effect on investment decisions. Since depreciated investments do not have to be marked to market, there is less aversion to acquiring long-term securities or loans. This fact undoubtedly helps issuers market those obligations under favorable terms. That helps the capital markets, but is counter to the interests of those that benefit from rational investment decisions. Market value accounting obviously is a preferable system, but the problem in implementation is in the periodic market value pricing. Securities prices are easily obtained from financial periodicals. Loans and fixed assets present a very different and complex pricing problem that would be difficult to overcome.

Until these problems can be addressed and a reliable market value accounting process can be developed, we can at least take some comfort in the fact that the combination of the balance sheet and the income statement tells the financial story fairly accurately. If a financial institution holds a large volume of heavily depreciated assets, that depreciation inevitably will be regurgitated periodically through the income statement. So, while historical cost accounting delays the effect of depreciated assets and fosters questionable practices as opposed to market value accounting, which would have an immediate effect and add more responsibility to investment decisions, both tell the same story in more or less unambiguous terms.

Again, thank you for the opportunity to testify concerning these important matters.

Chairman St Germain. Thank you, Mr. Sexton.

You stated that the interest paid should be indexed to something—I think you used the word Federal Reserve cost funds or something to that effect; right?

Mr. Sexton. Well, it would be indexed to the prevalent rate paid in that district among financial institutions.

Chairman St Germain. OK. That sort of sounds to me as if we are substituting VRE or regulated VRE for regulation Q, available rate interest that varies with the time within the market area that we are talking about. However, if that is the case, then everybody within that area would be paying the same interest rate. They would have a cap on what they could pay; correct?

Mr. Sexton. They would have a cap, but that cap would be above the average, 50 basis points perhaps above the average that is paid in that district. I believe that regulation Q presents a somewhat different matter in that it substitutes Government fiat for market judgment.

I would not have banks confined——

Chairman St Germain. The point is, Mr. Sexton, that when it comes to competition, the institutions within that area couldn't really compete for funds; could they?

Mr. Sexton. They could compete.

Chairman St Germain. But, there would be a maximim that they could pay; right?

Mr. Sexton. That is correct, but that maximim would be 50 or 75 basis points.

Chairman St Germain. But still, they would all have the same maximum?

Mr. Sexton. Correct. However, there comes a time when we have to cover the taxpayers and the deposit insurance funds.

Chairman St Germain. I don't disagree with you, Mr. Sexton. However, it took a long time to remove regulation Q. To reimpose it, I think, would be very difficult, but we appreciate your statement; it is obviously the result of very, very deep thought and commitment.

Mr. Silverberg will be our next witness, Director, Division of Research and Strategic Planning at the Federal Deposit Insurance Corporation.

Mr. Silverberg, we will put your entire statement in the record. You may proceed.

STATEMENT OF STANLEY C. SILVERBERG, DIRECTOR, DIVISION OF RESEARCH AND STRATEGIC PLANNING, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Silverberg. Thank you, Mr. Chairman.

Mr. Chairman, I have submitted a lengthy statement which I would like to place in the record.

Chairman St Germain. Without objection.

Mr. Silverberg. I would hope that you, the members of your committee and your staff will take the opportunity to read it. I have a few points I would like to try to highlight in the time allotted me in my oral statement. There has always been concern that deposit insurance would provide so much comfort to depositors and other creditors that they would cease to be concerned about the condition of their banks, thereby sheltering banks from private sector discipline. That concern was expressed by opponents of deposit insurance in 1933. Throughout much of the FDIC's history, when few banks failed, this concern was largely academic. As failures have increased and more banks, including large banks, face difficulties there has been more and more discussion both inside and outside the FDIC about the role played by deposit insurance in encouraging risk-taking by banks and insulating banks from market discipline.

A lot has been said recently about modifying the insurance system to restrain risk taking by banks. Until recently, two options generally were suggested: restrain risk by pricing deposit insurance premiums according to risk and increase market discipline by reducing de facto deposit insurance insurance coverage. Within the last year increasing support has developed within the FDIC for a third approach: raising capital requirements substantially and allowing subordinated debt to satisfy a significant portion of such requirements.

In my written statement, I indicate that I favor variable rate premiums. They are more logical and fairer than the present system. The system proposed by the FDIC of variable rate premiums is based principally on after-the-fact developments. Banks required to pay higher premiums would be those whose balance sheet and income statements indicate problems, as reflected in earnings, capital, nonperforming loans, et cetera. Because of imperfections in such systems and the potential for exacerbating existing problems, I don't think it is appropriate to rely principally on variable rate premiums for rectifying weaknesses in the deposit insurance system. Thus, while I think variable rate premiums they are a good thing and I think we ought to move ahead on them, I don't think they really provide the answer to the problems faced by the existing system.

I do not favor reducing de facto insurance coverage by handling bank failures through modified payoffs. Large depositors generally have enough opportunity, enough warning to run. When they do run we get into a situation where banks that might otherwise be turned around could be faced with rapid loss of funds even when they may well be solvent.

As a result, it may be difficult to turn around solvent problem situations. Another limitation of the modified payoff is that it provides little discipline for the many institutions whose depositors are virtually fully insured. Basically, I think that reducing de facto insurance coverage through the modified payoff or some other method contains more risk than potential benefit.

An alternative method of achieving market discipline and reducing FDIC risk is to raise substantially the capital requirement for FDIC-insured banks. An increased requirement would provide a large protective cushion to the FDIC and limit the extent that the insurance fund could be used to leverage a small capital base. There is a downside to high capital requirements: they make it hard to earn a satisfactory return on investment unless banks can operate with much larger spreads, that is, raise the price of bank services. That involves a cost to the public if indeed other institutions permit banks to increase their margins and, of course, any capital number tends to be somewhat arbitrary.

A way of mitigating the cost and arbitrariness of high capital requirements is to allow subordinated debt in the bank to meet a significant part of the capital requirement. That way, a well-run bank, perceived to be a good risk by institutional or public investors, will be able to borrow to maintain its overall leverage while increasing its capital cushion. The financially strong banking institution will be able to do this while incurring practically no increased capital cost because the funds can probably be employed to yield return comparable to the cost of borrowing.

A bank considered to be weaker by financial markets will have to pay much more for debt or it may have to rely more on equity. This distinction in market assessment can provide a useful market discipline. Note that we would be relying more on professionals with a longer-run investment stake than depositors typically have. In a sense, it would be the financial markets that would be determining the acceptable equity ratio for a banking institution.

It would be essential that bank regulators be uniform in applying capital standards. There would also have to be appropriate enforcement. If banks fail to meet standards, restrictions would be imposed on branches, acquisitions, et cetera.

If satisfactory progress through increased capital or asset shrinkage doesn't occur, supervisory pressure would be increased and, eventually, the institution might be closed even though it is still book solvent. That probably wouldn't occur very often because most troubled banks would find it more advantageous to recapitalize on terms that substantially dilute existing stockholders or to merge on not-so-favorable terms.

One of the problems with the present system is that troubled institutions try to hang on too long. They are reluctant to merge on someone else's terms and by the time they are willing to seek help, most of their franchise value has gone. Many of those who have testified before this committee and the Senate Banking Committee have stressed the importance of closing or merging failing institutions much earlier in order to limit insurance losses. This would be accomplished through the capital proposal I am suggesting, by raising the threshold at which supervisory pressure and capital demands are made. We would actually see fewer bank failures, more open bank mergers and more private sector solutions to banking problems.

Capital isn't meaningful unless a uniform satisfactory chargeoff policy is in place. It might also be necessary to factor in off-balance sheet exposure, though presumably investors in subordinated debt would most certainly factor in off balance sheet items in their calculations in determining the pricing and the rates at which subordinated debt becomes available.

However, if regulators can improve on capital ratios by appropriately factoring in off-balance sheet exposure and adjusting capital levels for nonperforming assets, I would have no objection to such a refinement of the capital proposal. Essentially, I view some risk-adjusted capital proposals and market value accounting as potential refinements to the method of calculating a bank's capital and the appropriate capital ratio.

Some argue that small banks will be disadvantaged by the capital because they won't have ready access to debt markets. First of all, small banks generally start with higher capital so that their need to raise additional capital will be less—the 12,000 banks $100 million or smaller in size currently have an average primary capital ratio of 9.1 percent. Well performing small banks have had access to subordinated debt in the past through correspondent banks, insurance companies and other private placements.

Finally, it is necessary to consider the impact of this proposal, taken as a whole, for small banks. It is apt to reduce their net insurance assessment, improve their ability to attract deposits compared with large banks and represent an overall improvement in the relative treatment of small banks compared with large banks in the present system.

While the capital proposal isn't perfect, it is, I believe, the best approach that is currently on the table. For the most part, it contains the right incentives and a reasonable mix of regulatory and financial market discipline. It is a proposal that can be phased in gradually, one that can begin to yield positive results almost immediately. Unlike proposals to reduce de facto coverage, we can begin to implement the capital proposal without imposing substantial risks on the system. And I believe the likely benefits of implementing the capital proposal are substantial.

[The prepared statement of Mr. Silverberg on behalf of the Federal Deposit Insurance Corporation [FDIC] follows:]

STATEMENT ON

THE NEED FOR CHANGES IN THE EXISTING SYSTEM OF FEDERAL DEPOSIT INSURANCE AND DEPOSITORY INSTITUTION REGULATION AND SUPERVISION

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

BY

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Room 2128, Rayburn House Office Building
September 18, 1985
10:00 a.m.

Deposit Insurance Reform

Federal deposit insurance has worked well in protecting depositors from loss, discouraging runs by smaller depositors and lessening the impact of bank failures on other banks and the business community. By contributing to depositor confidence and stability, insurance has reduced the number of bank failures and private sector losses associated with failures.

There has always been concern that deposit insurance would provide so much comfort to depositors and other creditors that they would cease to be concerned about the condition of their bank, thereby sheltering banks from private sector discipline. That concern was expressed by opponents of deposit insurance in 1933. Throughout much of the FDIC's history, when few banks failed, this concern was largely academic. As failures have increased and more banks, including large banks, face difficulties there has been more and more discussion inside and outside the FDIC about the role played by deposit insurance in encouraging risk-taking by banks and insulating them from market discipline.

Handling of Bank Failures by the FDIC

The manner in which failed banks have been handled by the FDIC has varied over time. For the most part, failures have been handled through payoffs to insured depositors and purchase and assumption transactions (P&As). In a payoff, a bank is closed and a receiver, generally the FDIC, is appointed. Insured depositors are paid by the FDIC. Those with deposits in excess of the insurance limit have a claim on the receivership for the balance of their claims along with other general creditors, including the FDIC, which takes the creditor position of insured depositors.

Assets of the failed bank are liquidated over time and, eventually, funds are distributed to general creditors. If general creditors are fully paid, there is a distribution to subordinated creditors and stockholders. In most cases, general creditors do not receive full principal, let alone foregone interest. Thus, subordinated creditors and stockholders usually get nothing and uninsured depositors and other general creditors incur some loss.

In a P&A, the failing bank is closed and all deposits and other general creditor claims are assumed by another bank. Typically the FDIC will remove classified and certain other loans from the failed bank's portfolio, mark the securities portfolio to market and provide cash to make up any shortfall between assumed assets and liabilities. Eligible banks or banking organizations are asked to submit closed bids on this package. The high bidder receives assets (of good quality), less the amount of its bid, equal to assumed liabilities.

It is important to note that all depositors, insured and uninsured, and other nonsubordinated creditors are made completely whole in a P&A transaction. The FDIC collects on the assets it acquires. However, subordinated creditors and stockholders do not receive any of these collections until the FDIC gets back all the funds it has advanced to make general creditors whole.

During the past 20 years, about three out of every four commercial bank failures, and most of the larger ones, have been handled through P&A transactions. Nearly all payoffs have involved situations where there were no interested bidders or where there was fraud and uncertainty about unbooked liabilities or other contingencies that made it difficult to place reasonable limits on the cost of a P&A. An uninsured depositor has stood the greatest chance to lose money in a failure where the bank was small and where fraud was present, even though he probably had no way to assess the likelihood of fraud. Prior to the Penn Square failure the largest payoff was in Sharpstown, Texas (about $60 million) where there were large potential claims related to lawsuits over securities violations. Between 1960 and July 1982 (when Penn Square failed) the banks paid off by the FDIC had average deposits of less than $8 million.

In connection with failing mutual savings banks, the FDIC entered into transactions very similar to P&As without actually closing failing institutions. Because these institutions did not have stockholders, the transactions were not complicated by a need to eliminate or subordinate any claims they might have. While assisted mergers have differed from P&As in several technical aspects, they have been effected under the same statutory authority as P&As, and in most respects the end result is similar. Deposits and liabilities of other general creditors are assumed by the acquiring or surviving institution. In a limited number of cases the FDIC has provided direct assistance to operating banks under different statutory authority. General creditors, of course, incurred no losses in these transactions, the most notable of which have involved three large banks: Bank of the Commonwealth in Detroit, First Pennsylvania and Continental Illinois.

Among those who have followed FDIC behavior in recent years there has been a general perception that the FDIC would not pay off a large bank -- at least not one with assets of several billion dollars -- and many probably thought not one the size of Penn Square, which had assets of $500 million.

The Impact of Insurance Coverage on Bank Risk

In most firms, creditors play an important role in restraining leverage and overall risk. If it is true that the FDIC can't or won't pay off a very large bank, then depositors and other general creditors at such a bank are not exposed to any risk. Stockholders and subordinated creditors are, but they are not the principal source of bank funding. This is not a phenomenon that has recently come about. It is true that the level of insurance coverage is very high today -- more than 90 percent of the deposits of banks with deposits of less than $100 million are fully insured and roughly another five percent are secured -- but most larger banks have had *de facto* 100 percent insurance coverage for some time.

Economists and others have recognized a lack of equilibrium for some time, but as long as there were few bank failures and most of them were small, this was largely an academic issue. In recent years the economic environment has exposed the banking system to increased risk. At the same time, competition among banks and between banks and other institutions has increased, and this too has made the environment less forgiving of bank management performance. Bank problems and failures have increased dramatically and, as a result, there is an increased concern that the present insurance system does not serve to restrain bank risk.

A lot has been said recently about modifying the deposit insurance system to restrain risk taking by banks. Until recently, two options generally were suggested: (1) restrain risk by pricing deposit insurance premiums according to risk; or (2) increase market discipline by reducing _de facto_ deposit insurance coverage. Within the last year increasing support has developed within the FDIC for a third approach: raising capital requirements and allowing subordinated debt to satisfy a significant portion of such requirements.

Variable Rate Insurance Premiums

Legislation has been introduced to give the FDIC authority to vary deposit insurance premiums within a fairly narrow range. As proposed, the FDIC would vary the assessment credit or rebate according to its assessment of bank risk. The maximum variation in net premiums from bank to bank would be about five basis points* (as a percentage of deposits); not a trivial amount, but not enough by itself to impair a bank's solvency. If such a plan were implemented and worked well, authority to vary premiums to a greater extent might be sought at a later date. The current FDIC legislative proposal also includes a provision that would allow the FDIC to charge problem banks for the extra examinations required by those banks.

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*The FDIC assesses insured banks 1/12th of one percent of domestic office deposits, subject to some minor adjustments. Operating expenses and insurance loss are subtracted from premium income, and 60 percent of the remainder is rebated to banks in the form of a credit on next year's assessment. When insurance losses were low, premiums, net of rebates, averaged between three and four basis points. However, during the past several years when insurance losses were much greater, rebates have been modest and net assessments have been in the seven-to-eight basis point range.

For some time many have considered the concept of variable rate premiums to be sound, but questioned whether a satisfactory system could be developed and implemented. One problem is that asset quality is a key to classifying problems and predicting failures. In the past we had to depend on examination reports to obtain such data for most banks. During the past few years banks have been reporting delinquent and nonperforming loans and these data substantially improve our ability to predict problems and failures from publicly reported data. The other problem which will not be readily overcome is that predictive systems still rely on after-the-fact events. Quality deterioration has taken place, whether through loan deterioration, operating losses or other events. Attempts to measure risk exposure based on loan concentrations, asset maturities and other characteristics that might precede poor performance have been less successful. At this juncture, the FDIC position is to move forward on a modest scale on variable rate premiums utilizing a system that relies on such variables as net income, capital and various measures of loan performance. Those banks that would not receive assessment credits would be those having problem bank or near-problem bank characteristics. Those banks facing current difficulty, most likely to fail and requiring greatest supervision would be penalized.

The system currently developed at the FDIC contains imperfections which we recognize. Nevertheless, we consider it to be far more rational and fair than the present system which makes no distinction with respect to risk.

Reducing Insurance Coverage

While some have advocated reducing the present $100,000 coverage, it is doubtful that the general public would support reduced coverage and I doubt that it would serve a useful purpose. The FDIC could try to handle most failures through payoffs, and last spring the FDIC tested a procedure designed to do just that -- the "modified payoff" transaction. Failing banks were closed and insured depositors were paid. However, the form of payment was the transfer of their accounts to another institution which also acquired the premises and certain other assets of the failed bank. Most checks in process were paid as is done in a P&A and most depositors probably were unaware of the difference. However, the liabilities of uninsured depositors and other general creditors were not assumed by the acquiring bank. The FDIC made a conservative estimate of the present value of future receivership collections and provided funds so that a cash advance (generally in the 50 to 60 percent range) could be made almost immediately to uninsured general creditors.

The modified payoff preserved many of the advantages of the P&A transaction. It was less disruptive than a straight payoff, while still retaining some discipline from uninsured depositors and other bank creditors. As indicated, there was little interruption in the payments process. Some of the value of the failed bank's deposits and facilities was preserved and these were sold through a bid process as in a P&A. The cash advance to uninsured creditors removed some of the "sting" of a payoff, although uninsured depositors were still exposed to some loss. The FDIC's experience demonstrated that this type of transaction, while people-intensive, could still be effected over a weekend -- even with a moderate-sized bank.

The modified payoff got mixed reviews among bankers and others, including FDIC staff. From the outset, we all knew that it could not be used for a really large bank, at least not any time in the near future.

As long as sophisticated observers of the FDIC doubted that a really large bank could or would be paid off, large banks would be placed in an advantageous position in competing for deposits. That advantage would be strengthened as more smaller banks were paid off and more depositors lost money in smaller banks. Indeed, the juxtaposition of modified payoffs for small and moderate-sized banks and the handling of Continental focused considerable attention on the fairness issue.

Some have questioned whether depositor discipline can really have a salutary effect on bank behavior. Depositors are not like security holders. In contrast to the latter, depositors can pick a bank whose condition deteriorates and still have enough warning to get out with no loss. When the bad news is out, security holders may stay with the investment if they anticipate survival or improvement. Depositors, on the other hand, don't have any incentive to stay. Thus, depositor discipline mostly comes after the fact. It is apt to hasten the closing of a troubled bank which is generally good if the bank would fail anyway. However, depositor flights may prevent a weak, solvent institution from turning itself around.

Another limitation of the modified payoff is that it provides little discipline for the many institutions whose depositors are virtually fully insured. This problem is exacerbated by the use of brokered deposits which expands the level of insurance coverage.

Recently the modified payoff has received support from some banking groups. They preferred it or viewed it as less expensive than increased capital requirements. I don't want to question the sincerity of large bank support for this proposal. However, a few points should be noted: Use of the modified payoff strengthens the competitive edge of large banks in competing for deposits unless a large bank is actually paid off. It also weakens somewhat the argument for extending the insurance assessment base to foreign office deposits which are concentrated in the largest banks. Consequently, the support of this approach by large banks is not surprising.

Capital Policy

An alternative method of achieving market discipline and reducing FDIC risk is to raise substantially the capital requirement for FDIC-insured banks.**

**A more detailed discussion of the capital proposal, along with responses to the most frequently raised questions about the proposal, is appended to my statement.

An increased capital requirement would provide a larger protective cushion to the FDIC and limit the extent that the insurance fund could be used to leverage a small capital base. There is a downside to high capital requirements: they make it hard to earn a satisfactory return on investment unless banks can operate with larger spreads, that is, raise the price of bank services. That involves a cost to the public if, indeed, competition with nonbanks permits an increase in margins. And, of course, any capital number, whether 5, 7.5 or 10 or whatever, is arbitrary.

A way of substantially mitigating the cost and arbitrariness of high capital requirements is to allow subordinated debt in the bank to meet a significant part of the capital requirement. That way, a well-run bank, perceived to be a good risk by institutional or public investors, will be able to borrow (at the bank or holding company level) to maintain its overall leverage while increasing its capital cushion. The financially strong banking institution will be able to do this while incurring practically no increased capital cost because the funds can be employed to yield a return comparable to the cost of borrowing.

A bank considered to be weaker by financial markets will have to pay more for debt or it may have to rely more on equity. This distinction in market assessment can provide useful market discipline. Note that we would be relying more on professionals with a longer-run investment stake than depositors typically have. In a sense, it would be financial markets that would determine the acceptable equity ratio for a banking institution.

it would be essential that bank regulators be uniform in applying capital standards. There would also have to be appropriate enforcement. If banks fail to meet standards, restrictions would be imposed on branches, acquisitions, etc. If satisfactory progress through increased capital or asset shrinkage doesn't occur, supervisory pressure would be increased and, eventually, the institution might be closed even though it is still book solvent. That probably wouldn't occur very often because most troubled banks would find it more advantageous to recapitalize on terms that substantially dilute existing stockholders or to merge on not-so-favorable terms. One of the problems with the present system is that troubled institutions try to hang on too long (they often are permitted to do so). They are reluctant to merge on someone else's terms and by the time they are willing to seek help, most of their franchise value has gone. The changes would result in fewer bank failures, more open bank mergers and more private sector solutions to banking problems. Capital isn't meaningful unless a uniform satisfactory chargeoff policy is in place. It might also be necessary to factor in off-balance sheet liabilities, though investors in subordinated debt would almost certainly factor off-balance sheet risk into their calculations before pricing and purchasing the debt.

Some argue that small banks will be disadvantaged by this proposal because they won't have ready access to debt markets. First of all, small banks generally start with higher capital so that their need to raise additional capital will be less (the 12,000 banks $100 million or smaller in size currently have an average primary capital ratio of 9.1 percent). Well performing small banks have had access to subordinated debt in the past through correspondent banks, insurance companies and other private placements. Finally, it is necessary to consider the impact of this proposal, taken as a whole, for small banks. It is apt to reduce their net insurance assessment, improve their ability to attract deposits vis-a-vis large banks and represent an overall improvement in the relative treatment of small banks compared with the present system.

Mr. Chairman, in your letter requesting my appearance before this Subcommittee you ask me specifically to comment on the merits and demerits of 12 "widely discussed deposit insurance reforms." I have already discussed my views on the modified payoff, subordinated debt capital and risk-related deposit insurance premiums. The balance of my testimony will be devoted to brief comments on the other nine "reforms" listed in your letter.

Risk-Related Capital Requirements

Risk-related capital requirements have received considerable attention lately, although such requirements appear to mean different things for different people. To some, they appear to mean requiring different capital percentages for different types of loans and investments. That presupposes that loans can be easily categorized by borrower or purpose and that appropriate risk levels can be ascribed to them. This, I believe, is a bad approach. Ascribing levels of risk to various types of loans is not likely to be sucessful. It does not take into account the degree of competence management of the bank may have to deal with the particular activity. Moreover, it is apt to be influenced by most recent experience. Thus, about five years ago some might have said that agricultural loans or energy loans are risk-free. This type of approach also tends to allocate resources and opens the door to using capital requirements for social policy.

Others, in looking at risk-based capital, focus more on after-the-fact risk as reflected in nonperforming loans and other qualitative variables. The federal banking agencies already factor this into capital policy so that banks with high levels of nonperforming or classified loans may be required to maintain higher book capital ratios. Possibly this could be done more precisely or formally so that one could translate levels of past due, non-accruing and otherwise nonperforming loans into some precise reduction in book capital levels. In that way it may be possible to develop a more uniform standard for capital. Thus, capital requirements of six or nine percent might somehow be translated into adjusted or "real" requirements of, say, five or seven percent. I have no quarrel with attempting to move in this direction, although I believe it will be difficult to develop uniform standards. It should be noted, however, that the FDIC's capital proposal, which allows subordinated debt to count for a large portion of the required level of capital, contains some of the same approach as the risk-related capital requirement I have just discussed. Under the FDIC "subordinated debt capital" proposal, financial markets would take account of all available data related to bank risk, including loan quality and off-balance sheet risk, in pricing subordinated debt and equity capital. Thus, it is the market place that determines the risk adjustment in that proposal.

Insurance Fund Recapitalization

While the FDIC experienced insurance losses of approximately $1 billion in each of the four years, 1981 through 1984, the deposit insurance fund (defined as the FDIC's net worth) increased from $11 billion to $18 billion, by more than 60 percent during the same period, and has more than kept pace with the growth of insured deposits. I believe the present level of insurance assessments is adequate to meet the risk faced by the FDIC, and I see no reason why there should be any adjustment to this approach or recapitalization of the FDIC at this time. Implementation of risk-based insurance premiums, which I favor, would allocate net assessments among banks differently, although in the FDIC proposal it would not affect the overall level of assessment income.

In contrast to the FDIC, the FSLIC appears to face significant financial problems. The FSLIC fund declined last year. This year, several large S&L failures will involve substantial costs and the fund may experience a further decline. Publicly reported levels of the FSLIC fund do not appear to take into account outstanding assistance commitments. Recently, the FSLIC has encountered many serious problems and some failures where asset quality and fraud have been dominant factors. These have proven to be very expensive and to require skills not currently present within the FSLIC. Potential failures and loss exposure could easily threaten the solvency of the fund. Very likely some form of recapitalization of the FSLIC fund or the combining of the FDIC and FSLIC will be necessary.

Insurance Fund Merger

I would favor merging the FSLIC and FDIC. It would reduce the likelihood of requiring taxpayer funds to recapitalize the FSLIC. There are other advantages to combining the two funds. It would facilitate implementing uniform capital, accounting and reporting requirements for all insured depository institutions. If deposit insurance is to have the same general characteristics, then I believe such uniformity is essential for reasons related to resource allocation, fairness and the preservation of insurance fund resources. I recognize that such standards for thrifts would have to be phased in over a relatively long period of time.

I believe there are advantages with respect to organization, efficiency and personnel in handling failures and liquidating assets that would develop from a combined fund. In addition, there would be more flexibility in handling failures and in developing standards with respect to levels of assistance to acquiring institutions, interstate acquisitions, permissible activities of acquirers, etc.

100 Percent Deposit Insurance Coverage

I would not favor explicit 100 percent deposit insurance coverage. However, if the FDIC's capital proposal were implemented along with risk-related deposit insurance premiums, I believe there would be fewer bank closings. Most banks that would be forced to go out of business would do so through private sector mergers without outlays from the deposit insurance fund. Most failures would probably be handled through purchase and assumption transactions by the FDIC and there would be less concern about depositor discipline since market place discipline would come from elsewhere. As a result, there would, in fact, be a very high level of de facto insurance coverage for banks of all sizes.

Reduced Deposit Insurance Coverage

If one believed that the modified payoff was the appropriate modification of the deposit insurance system, then some consideration would have to be given to reduced deposit insurance coverage since such a high percentage of deposits at banks and thrifts currently are fully insured. Depositor discipline would not mean much for those institutions having very small amounts of uninsured deposits. My own view is that reducing the level of de jure or de facto insurance coverage would involve a very difficult transition. There would be considerable risk of instability among financial institutions. If we could ever get there, it is not obvious the system would be improved.

I believe that many who advocate reducing insurance coverage have not looked that closely at some of the practical issues associated with paying off depositors in institutions with a million deposit accounts, the likely flight of depositors in response to unfavorable news about banks, the extent to which some bank creditors may be penalized by secured Federal Reserve advances or other closing delays, and other problems associated with paying off a large bank.

Greatly Intensified Supervision

During the past several years the number of bank examiners employed by the federal agencies and the states has not kept pace with the growth in banks and thrifts. The stretching of examination resources has been exacerbated by the high level of nonperforming loans, problem institutions and failures. I believe there is a need to expand supervisory resources substantially, which the FDIC is doing (its authorized examination force will grow by about 40 percent this year). I also believe that more complicated financial transactions and increased sophistication within financial institutions requires some overall improvement in the training and quality of supervisory personnel. In view of some of the differences in pay between the public and private sectors, I am amazed by the general quality of personnel that I have seen among the federal agencies. It is my impression that pay differentials have probably been widening, and I believe that effective supervision requires much more competitive levels of compensation than presently exist. While I believe that improved supervision is very important, I also believe that it is necessary to rely more on appropriate incentives among banks and their creditors and to increase market place discipline. I have already suggested how I believe this could best be done.

Market Value Accounting

While there is substantial logic in favor of using market value accounting, implementing such a system for 20,000 commercial banks and thrifts would be extremely difficult. If bank balance sheets appropriately reflected the value of loans and investments and various intangibles, balance sheet net worth would be an accurate reflection of the worth of an institution. Capital standards could be applied in a uniform fashion and the market place could readily gauge the net worth of an institution, the extent to which it was over- or under-capitalized, etc. Getting there, however, would be very difficult. There are many assets on the books of banks and thrifts whose value could (and perhaps should) be adjusted to reflect interest rate changes. These adjustments are simplest for investments and, indeed, most large banks publish information on market value appreciation or depreciation of investment securities. Market value adjustments for performing, quality fixed rate loans may not be too difficult, either. The degree of difficulty increases immensely when we adjust assets for quality. Generally, there is not much of a market for very risky performing and nonperforming loans, and placing values on these assets would be extremely difficult. The problem is somewhat similar to making appropriate adjustments in capital accounts in order to implement risk-related capital.

Some bank franchises reflect considerable non-balance sheet value because of a strong customer base, comparatively low cost liabilities, operating efficiencies, location, competitive, and other factors. These are extremely difficult to measure. In principle, one might argue that these intangibles are reflected along with asset quality and interest rate associated depreciation in the market value of an institution's stock. However, as Professor Kane and others will tell you, the market value of the stock of an institution with deposit insurance also reflects some value of that insurance. Thus, stock values are an imperfect gauge. Moreover, the vast majority of bank stock does not actively trade in the market and as for thrifts, many are not stock institutions. A gradual movement toward market value accounting would probably be in the public interest; however, it must be appreciated that even partial market value accounting adjustments might suggest that a very large percentage of the thrift industry is insolvent.

Private Deposit Insurance

I do not think there is likely to be an important role for private deposit insurance in our system. Unless we were to move toward more payoffs, or modified payoffs, there probably would not be a very strong market for private insurance. Assuming we would go the modified payoff direction (a direction which I do not favor), then I could foresee some limited role for private insurance. I do not think the insurance industry is in a position to take the kind of risks that would fully cover the non-insured gap for larger institutions. I could foresee a market for private insurance of deposits in moderate-sized institutions, where depositors or banks might pay a premium for additional insurance coverage. There is probably sufficient information in the public domain for a private insurer to vary premiums according to some selected financial ratios (much like risk-based premiums that the FDIC might charge). Whether all this would be of particular importance to the functioning of the banking system is something I am uncertain about. If, in fact, deposit insurance coverage relies principally on purchase and assumption transactions, I do not see a strong market for private insurance emerging. I doubt that depositors or institutions would be willing to pay a sufficient premium to make the provision of that insurance worthwhile to private insurers.

Brokered Deposit Restrictions

Brokered deposits currently expand deposit insurance coverage and facilitate the marketing of deposit insurance for private institutions. Those who favor the modified payoff or some significant reduction in insurance coverage have to come to grips with the brokered deposit problem. To the extent that deposits are exposed to considerable risk, the volume of brokered deposits is apt to expand significantly, and the problem created by brokered deposits will expand. Some form of restrictions will absolutely be necessary.

If we moved to higher, enforceable capital standards, and these standards, indeed, are enforced, then the problems presented by brokered deposits would be diminished. Institutions would have to earn sufficient margins on the funds to support the increased capitalization and many of the problems we have experienced with respect to brokered deposits probably would be diminished.

In today's market, many of the institutions aggressively marketing brokered deposits are substantially undercapitalized (some are probably insolvent). They are relying solely on deposit insurance as a means of raising funds. We hear much discussion about brokers facilitating the free market movement of funds; however, when institutions are insolvent or don't have to meet capital costs, there is not much logic in discussing the role of the free market. Clearly, such institutions could not and would not survive in a free market environment without deposit insurance.

Mr. Chairman, while my written testimony may seem lengthy, my discussion of each of the specific deposit insurance proposals is brief. I will be pleased to develop my views in more detail on any of these proposals should you have any questions.

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Economic Outlook is published monthly by the FDIC's Division of Research and Strategic Planning. Questions, comments and requests for copies can be directed to John Bovenzi (Tel. 202/389-4321).

BANK CAPITAL REQUIREMENTS AND THE DEPOSIT INSURANCE SYSTEM

For some time there has been concern that the deposit insurance system insulates most bank creditors from risk and, as a result, there is insufficient market restraint or discipline imposed on banks. The FDIC's Deposit Insurance Study suggested that market discipline could be attained by significantly increasing bank capital requirements while permitting subordinated debt to satisfy a portion of the requirement. This suggested approach has gained increased acceptance within the FDIC and it has received increased attention, and some support, outside the FDIC. The purpose of the comments that follow is to spell out how the approach would work, suggest responses to the most frequently raised questions about the appproach, and indicate some unresolved issues that would have to be addressed if the approach were to be implemented.

The Proposal

Bank capital requirement would be raised substantially over a period of several years to a level of, say, nine percent of assets. At the same time regulatory capital policy would be revised so that subordinated debt could meet a substantial portion of the capital requirement (one-third). The additional capital would provide an enhanced capital cushion for the deposit insurance fund and, as will be suggested, would probably result in fewer bank failures.

Those banks perceived to be in a strong financial condition probably would be able to borrow on a subordinated basis to meet the additional capital requirement without significantly impairing earnings. Some would be able to lend out acquired funds on a sound basis at returns comparable to their borrowing cost. Even if costs exceed rates earned on acquired funds by one or two percentage points, the banks' overall reduction in net interest earnings would only be 3--6 basis points (.01 or .02 x 3 percent of assets). Those banks perceived to be riskier would have more difficulty borrowing. Their cost would be high or else they would have to meet the higher capital requirement partly or wholly through a higher equity ratio: by contracting, by reducing dividend payments or by the sale of equity. Whether subordinated debt is used would be a marketplace decision, so that it would be the market that ultimately sets a bank's equity ratio and determines the cost of the increased capital requirement.

Market Discipline

Investors in subordinated debt are likely to be in a better position to assess risk and exercise market discipline than bank depositors. Most will be institutional investors or other banks able to devote resources to evaluating a bank's condition and the riskiness of their investment. Their time horizons will be longer than most depositors. When a bank encounters difficulty, uninsured depositors generally have ample notice so that they can get out without loss and, incidentally, exacerbate the bank's problem. They generally have no incentive to stay with the troubled bank, even if they believe the bank will survive. They won't be sufficiently compensated for the risk and if they are managing a company's or other people's funds, prudence and job security dictate that they pull the funds out.

Investors in subordinated debt will be exposed to potential market loss if the condition of the bank deteriorates, even if it never fails. Thus, they have more reason to appraise management policies. Once a bank gets into difficulty, efforts by debtholders to get out (by selling in the market) won't cause a liquidity problem for the bank except to the extent that market conditions impair future bank financing. Debtholders or potential lenders that have confidence in the ability of the troubled bank to improve its situation can hold or purchase bank debt and gain in the marketplace if their assessment of the bank is correct.

There is another argument why "capital discipline" may be superior to depositor discipline. At the present time 80 percent of domestic deposits is insured. A much higher percentage of deposits in all but the largest banks and most savings banks are insured. Many institutions expose the FDIC to considerable loss even though their deposits are almost fully insured. Depositor discipline can have little impact on those institutions unless insurance coverage were reduced, an extremely unlikely development.

Phasing In An Increased Capital Requirement

Banks would be given several years to phase into the higher capital requirement. That way, they would have some flexibility in timing their financing and financial markets would not be overwhelmed by bank financing. However, it is contemplated that those banks relying on subordinated debt would come to market frequently and be exposed to market discipline continuously. Much of the financing is apt to be intermediate-term or retired on a serial basis. However, even where longer-term debt is used, banks seeking to maintain their overall leverage would find it necessary to add to their debt periodically as their asset base grows.

Enforcement of Capital Requirement

For the proposed policy to be effective, capital requirements would have to be enforced by all supervisory agencies. Once a bank falls below the requirement, some restrictions would come into play immediately. These might include a prohibition on new branches or acquisitions, possibly a higher insurance premium, etc. As time and/or the capital shortfall increases, additional sanctions might come into force (possibly dividend restrictions or restrictions on some types of deposit-taking or lending). At some point, action would be taken to close the bank. Authority for Federal regulators to close solvent banks would probably require Federal legislation. In most instances, actual closings will be averted because bank management will find it in its and the bank's interest to take drastic action. This might take the form of selling off branches, raising capital or merging. Under adverse circumstances the sale of capital might significantly dilute existing shareholders or merger terms might be "unfavorable". However, actions that appear to treat shareholders adversely are apt to be better than the alternative -- having the bank closed.

This is an important point of the capital proposal. By setting capital standards high enough and setting the level where sanctions come into force high enough, many bank failures are apt to be averted. They would be replaced by recapitalizations or mergers where FDIC or other supervisory involvement is limited. From a financial standpoint there would be no FDIC involvement where the system works well.

Under present arrangements, enforcement action sometimes pressures or awakens bank management to recapitalize or merge so that failure is averted. However, frequently the troubled bank is too far gone by the time it considers recapitalizing or merging. The proposal put forth here would require drastic action while the troubled bank is still likely to have value. That is likely to spur management and directors to take action to salvage some of that value.

Fewer bank failures and reduced FDIC outlays will reduce net insurance assessments. These currently run about eight basis points measured as a percentage of deposits. Prior to 1981, when FDIC insurance losses were modest, net assessments averaged four to five basis points. For those banks that incur increased net interest cost through the use of subordinated debt, a portion, all, or perhaps more than all, of that increased cost could be offset by a reduction in net insurance assessments.

Following are the most frequently raised questions about the capital proposal along with responses to these questions.

Will higher capital requirements reduce bank lending and adversely affect the overall economy? Enforced capital requirements will cause some banks to reconsider taking on some low margin volume that would have to be capitalized. However, such evaluation should have always been part of rational bank planning. If banks are able to borrow to meet all or most of the additional capital requirement, there would be no significant reduction in bank loan growth and no adverse macro economic effect. Insofar as bank borrowing is from nonbank sources, the financing of bank subordinated debt can be viewed as an exchange of IOUs between banks and various other sectors of the economy -- the public, nonfinancial firms and other financial institutions. If some phasein is permitted to get banks up to the desired capital level, the impact of the financial transfers will be modest.

Because large banks have easier access to capital markets, won't this proposal favor large banks? Not necessarily. First, smaller banks as a group have higher equity ratios than larger banks and, historically, have been able

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to add to equity from internal sources more easily than large banks. Thus, many smaller banks will have less need to supplement capital externally. Second, smaller banks in sound financial condition *are* likely to be able to sell their subordinated debt on favorable terms *to* correspondent banks, institutional investors and, in some instances, to their own customers. They would not have the name or size to sell in national public markets, but the cost edge to large banks that can sell public is apt to be modest.

Finally, the impact of this proposal on small versus large banks should be examined within the context of the functioning of the deposit insurance system. If, instead of the suggested approach, the FDIC sought to instill market discipline by reducing *de facto* insurance coverage, uninsured depositors at smaller banks are apt to consider themselves exposed to more risk. Unless the public believes that even the largest banks will be paid off by the FDIC, the insurance system would continue to favor large banks.

Will unfavorable response to high debt-equity ratios by rating services make it difficult and expensive for banks to sell subordinated debt? It is difficult to anticipate how rating services, bank analysts and underwriters will respond to the increased use of subordinated debt. I believe that rating services would ultimately appreciate that, as long as a bank has satisfactory equity relative to total assets and liabilities, more subordinated debt would not necessarily pose a problem. It is important to realize that some of the financial rules-of-thumb applied to debt coverage for nonfinancial firms are not altogether applicable to banks. Banks should have little difficulty servicing debt (interest or amortization payments). Banks typically accommodate deposit fluctuations that are much larger than any cash drains associated with subordinated debt. As markets gain experience with expanded use of subordinated debt, rating services will make appropriate adjustments. Underwriters may develop new instruments and we are likely to see a variety of marketing techniques (including marketing to bank customers), and variations on interest payments (fixed, variable tied to different security rates, no coupon, convertible, etc.).

Won't higher capital requirements encourage banks to acquire riskier assets? The use of subordinated debt will enable banks to maintain a high degree of leverage while still providing an increased cushion to the FDIC. If the market perceives that a bank is reaching for riskier assets, subordinated debt will become more expensive and difficult to acquire. If a bank takes on additional risk and incurs losses, replacing or adding to required capital will become expensive and difficult. Thus, the proposed system contains elements that will discourage excessive risk-taking.

Won't banks be encouraged to shift activities off balance sheet to conserve on capital? Yes, they probably will. If banks or bank holding companies acquire power to run mutual funds, they may seek to shift some retail deposits -- particularly related to IRA and Keogh accounts -- to mutual funds. That should pose no special problem for bank performance or bank regulators. Banks may also seek to increase income without increasing their balance sheet size through various devices (loan guaranties, etc.) that do increase the bank's risk. It will be necessary for bank regulators to limit such exposure or else factor it into the asset base for determining the capital requirement.

Is there any evidence that higher capital requirements will reduce the number of bank failures? Obviously, most banks that fail have run out of capital. The more interesting question is whether there is a relationship between capital ratios and bank failures when several years' lead time is used. When adjusted capital ratios are used, the relationship is not that strong and some have drawn from this to suggest that capital is not importantly related to bank failures. However, most bank examiners know that when capital is adjusted for asset quality (whether measured by classified assets, nonperforming assets, delinquencies, etc.) there is a very important and predictive relationship.

The report by James Marino in the November *Outlook* pointed out that adjusted capital ratios for failed banks were dramatically lower than those of their peers several years in advance of their failure. I believe the important and relevant conclusion from the Marino study is that adjusted capital ratios are much more closely related to bank failure than book capital without appropriate adjustments for asset quality. This suggests that required capital ratios should be calculated after appropriate adjustments. These might be based on nonperforming loans or other publicly reported data. At a minimum, more rigorous and uniform chargeoff policies probably are necessary. In addition, it may be appropriate to subtract some percentage of delinquent or nonperforming loans from capital and, possibly, requiring slightly lower capital ratios.

How are the proposed capital requirements affected by the capital structure of bank holding companies? The proposed capital requirement would be at the bank level. A parent holding company might borrow a portion or all the amount of the increased requirement and place it into the bank as equity. While there are some differences, the effect would not be much different than borrowing at the bank level. Presumably, potential lenders would assess the financial condition of the holding company (whose principal asset may be the lead bank) and much the same market discipline would come into play. In principle, borrowing could occur at both the bank and the holding company level. We would expect market forces to impose restraints on overall leverage, although regulatory agencies may seek to impose some overall equity minimum. My own view is that that would not be necessary.

There are advantages to borrowing at the bank level from the standpoint of the borrower, lender and the FDIC. If the principal asset of a bank holding company is the lead bank, debt in the bank represents a more senior claim on bank assets than debt in the holding company and, other things equal, the former should sell on a lower yield basis than the latter. Interest and amortization payments normally are relatively easy to service in banks. Servicing doesn't necessitate profitability. Bank holding companies do not always have such easy access to cash. Transfers from the bank are limited, especially if the bank can't pay dividends, and other cash sources may sometimes be limited.

Restrictive covenants on bank debt can generally be controlled by regulators. In the current proposal regulators could deem subordinated debt unsatisfactory for meeting capital requirements if, for example, an acceleration clause was present. Holding company debt sometimes contains covenants that restrict the sale of the bank or restrict dilution of bank stock. Such covenants may act counter to resolving problem bank situations by forcing bank sales or mergers. Whether the presence of such covenants are likely to pose real problems probably needs some additional examination.

How would the capital proposal mesh with the handling of failures (P&As versus payouts), variable rate premiums, and the treatment of brokered deposits? If the capital proposal were implemented, capital, including subordinated debt, would afford additional protection for the FDIC and impose marketplace discipline on bank behavior. Most likely there would be fewer failures, and less reason to impose losses on depositors by paying off banks. Most failures would probably be handled through P&As except in those instances where there is no available purchaser or where financial uncertainties make a P&A very risky.

Implementing the capital proposal would not preclude a system of risk-based insurance premiums. However, that would involve the FDIC's basing insurance costs on criteria similar to the market's determination of capital costs. A possibility previously mentioned would be to impose a higher premium on those banks that fail to meet capital requirements. This would not preclude more severe sanctions if the capital shortfall persists and/or increases.

Brokered deposits provide a means of expanding and trading on insurance coverage. Without significant reliance on depositor discipline, deposit brokering becomes less important, although supervisors are still apt to monitor the exposure that comes from excessive reliance on brokered deposits. Brokered deposits, like other deposits, would have to be capitalized and if they are high-cost or their use otherwise entails high risk, that will be reflected in their capital cost.

Won't higher bank capital requirements adversely affect the relative competitive position of banks compared with thrifts? Yes, if higher capital requirements do impose costs on banks. Banks are currently disadvantaged because thrifts have lower capital requirements and because their pricing of deposits does not adequately reflect capital costs and market forces. Savings and loans have experienced substantial low margin growth in recent years, transferring a substantial amount of risk to the FSLIC.

Thrifts should be subject to the same capital requirements as banks. The condition of most thrifts makes it unlikely that satisfactory capital levels could be achieved in the near future, and it is not feasible to close most capital-short thrifts. Institutions that are allowed to operate with insufficient capital should be subject to sanctions. In particular, limitations should be placed on their growth. Recent Bank Board capital proposals would be a modest step in that direction.

Chairman **St Germain**. Mr. Silverberg, you discussed off-balance sheet exposure. We had testimony last week, the questioning of the witnesses from the Fed for instance, which indicates that the only measure of off-balance sheet exposure available at this point is on the letters of credit.

Now, does the FDIC have a more adequate reporting system? Can you educate us here and tell us a little bit about what the off-balance sheet exposure is beyond the letters of credit?

Mr. **Silverberg**. Mr. Chairman, there is a report form that banks fill out—if you like, I will submit a copy of that—that lists a number of other items. These include loan commitments, various types of obligations in connection with foreign exchange transactions, interest rates, swaps, et cetera. I think, however, there is a general feeling among the three Federal agencies that the form and the information we get is probably not as good as what we need.

Chairman **St Germain**. As a matter of fact, let me ask you this. How frequently have you amended that form in the past 3 years?

Mr. **Silverberg** I don't really know the answer to that. I suspect this form is currently about 2 years old, but I don't know.

Chairman **St Germain**. All right. Is it not a fact, with the ingenuity being employed in those institutions at this point and the innovative tendencies that exist, that off-balance sheet exposure varies and that new items come up almost on a monthly basis?

Mr. **Silverberg**. Yes. I think that is correct.

Chairman **St Germain**. So that indeed this is a very difficult item to be sure of?

Mr. **Silverberg**. Right. I would say, Mr. Chairman, that right now the FDIC and the Comptroller have been jointly visiting a number of larger banks. I believe the Federal Reserve is also undertaking a substantial effort to try to get a better sense of what some of these exposures are.

I must admit that in many respects we are not as knowledgeable as we probably need to be. Many of the items involved, while very substantial in amount, do involve situations where positions are relatively matched and exposure may not be great.

So while we have seen items that have suggested off-balance sheet exposure exceeding a trillion dollars, et cetera, I think there has also been in the public a lot of exaggeration as to how much risk is actually involved in some of these items.

Chairman **St Germain**. Mr. Carron, two things. No. 1, in your opinion should foreign deposits in domestic institutions be insured and—in other words, should or should not those institutions pay depositors insurance on those foreign deposits?

Mr. **Carron**. Mr. Chairman, there are a number of anomalies and equities, if you will, in the assessment structure. For example, we only insure deposits up to $100,000 per account and yet we charge the deposit insurance premium on total deposits, whether insured or uninsured. However, we then exclude the overseas deposits. A further point to make on that is the banks that have these large overseas deposits are typically the ones that we refer to as too big to bailout.

So, from the point of view of the Government's implicit guarantee that these banks will not fail and that, therefore, the overseas depositors will be protected as well, equity would seem to demand that the premiums be charged on overseas deposits.

Chairman **St Germain**. Professor Kane.

Mr. **Kane**. Well, I would make some of the same distinctions, that what we do in a decision like this depends on what we do on some other items.

Chairman **St Germain**. We recognize that, Professor Kane.

Mr. **Kane**. I wanted to qualify my answer because making an other-things-equal assumption is the only way I can approach the question.

Chairman **St Germain**. We realize that we can't take these separately. They have to be part of a package.

Mr. **Kane**. If authorities don't change their policies of insolvency resolution, so that they continue, in fact, to bail out any large bank that gets into serious trouble, it would be appropriate to charge every class of creditor for the de facto insurance coverage that it receives

Premiums might even be extended to subordinated debtholders and to holders of holding-company debt. We could go on and on. Enlarging the premium base would be an improvement, if that is the only thing Congress chooses to adjust.

I would urge that, instead of firming up de facto coverages, Congress try to introduce more depositor discipline into the system. This means providing better information and charging in various ways for the risks imposed on the taxpayer. In this case, we could choose to classify foreign depositors as parties whose debts are uninsured, but regulators would have to enforce their claims against creditors of failed institutions.

If insurers don't enforce such claims, they ought to charge for the de facto credit support they supply.

Chairman **St Germain**. Mr. Sexton.

Mr. **Sexton**. I would agree with Professor Kane—except in one instance. I don't believe that the subordinated creditors should be figured into that process. In the normal course of business those are not covered in a purchase and assumption transaction but I do believe that these foreign obligations on the books of the bank flow through purchase and assumption transaction and, therefore, should be assessed.

Chairman **St Germain**. Mr. Silverberg, in this instance, tell me whether you are speaking for Mr. Silverberg or the FDIC.

Mr. **Silverberg**. I find it easier to speak for Mr. Silverberg on this. In view of my support for the capital proposal, I would favor extending the assessment base to foreign deposits as well.

On the other hand, if I thought the best approach was to go with a modified payoff as the standard approach, then I think it would be consistent not to include them.

Chairman **St Germain**. Let me ask you something, Mr. Silverberg, and I am going to ask this of Professor Kane as well. In the Continental Illinois situation, try to remember the very, very delicately worded statement of Mr. Isaac that no one would lose any money. He didn't say what everybody in this great wide world thought he said; that is, that the FDIC, this insuring fund would cover everybody without limitation. What he meant, which he subsequently told us, was that the FDIC was going to see to it that Continental would not close and, therefore, fail.

Now, do you feel that the suggestion you made to us this morning would be adequate so as to allow a Continental Illinois to fail if it had to fail, or do you think we would have the regulators come in here and tell us, well, we couldn't let it fail because there were so many hundreds of other financial institutions with deposits in excess of $100,000 and that there were so many businesses with loans and loan commitments that would fail if we allowed Continental Illinois to fail?

Furthermore, as you recall, in Continental we also protected the holding company. Is there anything in your proposal that would guarantee that we would not protect and insure the holding company, and the bond holders in the future?

Mr. SILVERBERG. Can I go back to your original statement and take a few minutes to respond to that?

Chairman ST GERMAIN. Certainly, because, gentlemen, let me say this. In my opinion, we started our hearings on deposit insurance reform when we held the hearings on Continental Illinois. We held further hearings on deposit insurance reform when we held the hearings on Golden Pacific Bank, because we had to look at the different manners in which financial institutions, as well as depositors, are treated when catastrophes come about. So, yes, indeed, please go back, Mr. Silverberg, because Continental is an intimate part of this.

Our big problem is that we will continue to have fail-safe banks no matter what we do on reform. We can't get away from that, can we?

Mr. SILVERBERG. We recently went through an exercise of reviewing what was done in Continental. I think the general view, certainly my view was that the press release should have been much more explicit. Basically, what the press release should have said on May 17 was that the banking agencies have decided not to pay off Continental.

Now, what that means is that Continental would be handled either through an unassisted merger, through a purchase and assumption transaction or, as it was ultimately done through direct assistance. Once the decision was made not to pay off Continental, that decision was irrevocable because by delaying and funding the outflow of depositors, it is unfair to make that decision and then change your mind.

Now, let me say in terms of the proposal that Mr. Sexton and I both support Continental and most banks would probably not be paid off. It would probably under ideal circumstances be handled as a closed bank purchase and assumption.

Now, in the course of trying to decide what to do, once the FDIC, the Fed, and the Controller——

Chairman ST GERMAIN. Excuse me. Mr. Silverberg, we all realize that there were a lot of people who looked at Continental, teams of better than a hundred people went in.

It is an assumption. We are talking about when you have that larger institution that is in trouble, there are very few people around who have any reason for coming in and purchasing it.

Mr. **Silverberg**. Yes, but I think, Mr. Chairman, it is important to appreciate that in going through the sequence, that had there been a purchase and assumption transaction available that did not involve enormous costs, the FDIC probably would have gone that route.

So the initial decision was not necessarily to keep Continental alive. The initial decision was not to pay off the insured depositors because for various reasons that was viewed as being extremely disruptive. I think that was the right decision.

Now, the question, the next question I guess you are raising is if Continental were to come up again or something similar, would there be a purchase and assumption transaction available?

Chairman **St Germain**. My question is this: What is there in the FDIC's proposal that would preclude or say to the world at large that we are no longer going to distinguish between a small, tiny, helpless institution and a large institution like Continental? That is my question. Under this new proposal, would this very distressing and disturbing situation be cured?

Mr. **Silverberg**. I couldn't give you assurances that it would cure the Continental problem. What it would have done is place demands on Continental much earlier to raise capital, to either shrink in size or basically improve its situation. Now, whether or not in 1982, or 1983, Continental would have been in a position to have effected that, I don't know. Some people think there were assets that could have been sold off, some shrinkage could have taken place, that possibly they might have been able to find a merger partner earlier.

I cannot give you any assurances that would have succeeded because their situation was difficult. They were a large institution, interstate barriers made it very difficult for them to do an open bank merger. This proposal would have put a lot of pressure on Continental much earlier in the game to try to take action to seek some sort of help.

On the other side, if this capital proposal were implemented, the general practice would be to handle almost all bank failures through purchase and assumptions, so that depositors and smaller banks that failed would typically be fully insured. In that sense there would have been somewhat more uniform treatment as well.

Chairman **St Germain**. Professor Kane.

Mr. **Kane**. Thank you very much.

I think the Continental Illinois case was a test of the FDIC's then-evolving new strategy of trying to evoke depository discipline. The FDIC failed this test. By employing modified payoffs to resolve several failures earlier in the year, the FDIC had scared uninsured creditors of all types. Speculators saw Continental Illinois as weakest of the large banks and began to move deposit balances away from it lest they be caught in such a payoff.

The Continental deal amounts to an open-bank government purchase and assumption or P and A. We had a nationalization of Continental Illinois. Authorities didn't call it by that term, because a government entity took a dominant options position instead of a dominant stock position. Federal officials determined who the managers would be. They could have replaced management without bailing out uninsured creditors. But they chose not to kill the bank corporation.

They certainly didn't have to bail out the holding company. They chose a bailout because they wanted to keep that corporation alive and covenants in holding-company debt gave its debtholders rights to resist a change in control. Officials could have conducted a closed-bank government P and A. If for some legal reason a closed-bank transaction couldn't be arranged, something must be fundamentally wrong with the insolvency-resolution and supervisory policies of the FDIC. In any case, it teaches us that authorities should review covenants in holding-company debt. Statements embodied in holding-company debt shouldn't disadvantage the deposit insurer who stands as a third and silent party to such contracts. I would urge Congress to pass a law making any covenants that abridge the deposit insurer's rights null and void.

A deep point that lies behind your question is very important. Deposit-insurance costs vary with the policies of insolvency resolution that are followed. If insurer exposure to losses in insolvencies is very closely controlled, the costs are less than if authorities generally bail out all parties involved.

I can tie the question back to market-value accounting. One of the problems in liquidating an insolvent institution—that is, stripping apart its portfolio to sell its assets and offices—and paying off its depositors is that the values recorded on its books are not very meaningful. In Ohio's deposit run, the Governor and legislature had no immediate way of assessing what the troubled S&L's were actually worth. The advantage of market-value accounting is that it would require under penalty of criminal and civil penalties—depending on how the law is written—that accountants and managers give their best estimates of what assets and liabilities are worth and document these estimates so that others can in reasonable amounts of time ascertain what an institution is worth.

Today, it is impossible to look to the books of any failing institution to figure out what it's worth. Potential takeover partners cannot in a few days ascertain what would be a resonable takeover bid. Market-value accounting would lessen all those problems.

Chairman St Germain. It seems to me we had GAO here last week. GAO was here last week and I don't know if you are aware of the fact that a letter from GAO was not included in this year's FDIC report are you?

Mr. Kane. I am. In fact, my written testimony notes that.

Chairman St Germain. OK, because the FDIC was questioned—well at this point in time it is still impossible to replay and give an estimate of the worth of those assets and why they were an issue with GAO. GAO felt that they should have at least given an estimate.

Now, don't forget, I am asking you to tell us whether you feel the proposal propounded by Mr. Silverberg on behalf of FDIC would eliminate this apparent differentiation that now exists between a small institution and a fail-safe, large institution?

Mr. Kane. The short answer is: "No"; I don't believe so. My concern about the FDIC's subordinated-debt proposal is that the FDIC speaks as if it were a complete solution when it is at best only a part of a full solution. If insurers used uniform and well-understood-economic principles to guide their resolution of each insolvency and if they had established appropriate controls over covenants in holding-company debts, then subordinated debtholders at giant banks might feel that their capital was at risk. But to the extent that bureaucrats see large-bank failures as administratively too hard and macroeconomically too disruptive to endure, they would rather not pay off a large bank or force a market solution on its stockholders. Anyone can understand the difficulties that tough insolvency-resolution policies would raise for a sitting President and a sitting Congress. The tendency is for regulators to slide through each problem with minimum market turbulence. Why run the risk that the problem will spread to other institutions and produce a nasty crisis?

Because I believe this way, if I were a holder of the subordinated debt of a giant bank and found myself earning a large risk premium on the bank's debt, I would be laughing up my sleeve. In fact, I would buy more of the debt as long as the premium remained large. Of course, arbitrage pressure of people like myself ought to drive down the premium. Authorities won't win much effective monitoring until they alter their insolvency-resolution policies and until institutions employ accounting principles of the kind that allow the subordinated debtholders to asses the risks they are presumed to bear.

Chairman ST GERMAIN. Mr. Carron, of Shearson Lehman Bros., Inc., right now, people in your firm can recommend to their clients that if they are looking for safe bank stock from one of the big 10, that they need not be concerned that they will ever lose all of their money because, as of now, the Federal Government, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Comptrollers Office, will not allow any of those institutions to fail; therefore, it is a good investment.

Now, would you address the question I pronounced to Mr. Silverberg and Mr. Kane. Have you heard anything here this morning that would address this dilemma? Should we continue to accept the fact that there are going to be some fail-safe institutions, yet you can also have failed institutions?

Mr. CARRON. Well, I certainly don't disagree with anything that Edward Kane said, but let me amplify and extend that a bit. You have a dilemma when you talk on the one hand about maintaining stability in the system, and on the other hand about imposing discipline on the institutions. If you want large uninsured depositors to impose that discipline on the banking system, then you are also going to make the system less stable than it now is, because at the first sign of trouble those deposits will flow out—thereby imposing very rigid discipline, which is good, but also creating a lot of instability in the system, which is bad.

Chairman ST GERMAIN. That is what happened at Continental, right? The word went out, the telegrams and teletypes went out all over the world, and those moneys were withdrawn with utmost alacrity.

Mr. CARRON. And interest rates not only at Continental Illinois, but throughout the banking system, showed a perceptible increase as a result of that. So that if you put this policy into place, and say large uninsured depositors will not be protected, or at the very least they have no assurance of being protected, then what we saw happen at Continental, and which was pretty much confined to Continental, could happen simultaneously in a large number of institutions.

So, on balance, I tend to like the idea of imposing discipline. Maybe you go in the direction of subordinated debt, which can't be withdrawn because it is longer term investment, and say we are not going to protect subordinated creditors, but maybe we will protect the big depositors. And in my testimony I suggest that maybe what you want to do is protect the money that can most easily run out of institutions, the demand deposits, and that gives you the stability, but you don't protect fully the time deposits and don't protect at all the subordinated debt. Maybe that gives us the kind of stability that you want. So that was one point I wanted to make on stability.

The second point on increasing capital goes back to my original comment where I wanted to distinguish between preventions and cures. If you put this plan into place today, there is no way that the institutions with greatest problems today can raise the capital that would be needed to meet these requirements. The thrift industry, which has by some estimates, less than 1-percent tangible——

Chairman **St Germain**. Mr. Carron, we know they are in a bad situation. Why don't we stick with the commercial banking industry? Very frankly, I think we both know, and probably all of us know, that there are some commercial banks that couldn't raise that, couldn't sell any subordinated debt today if the accounting principles Professor Kane cited a few moments ago were to be put into place. Is that not correct?

There are some institutions that you are not recommending your people invest very much in if they are looking for a return on their investment because——

Mr. **Carron**. I am not in the equity side of the business.

Chairman **St Germain**. You must hear a little whisper here and there.

Mr. **Carron**. We recommend some stocks and not others. But my point exactly is that the institutions which are perceived to have problems will not be able to raise the capital that would be necessary to prevent the problems and so you don't really help yourself in the short run.

Now, in terms of new banks coming into the system, and over a period of time, you could get the existing banks up to some level, that is your prevention that I was talking about. That is what keeps these from happening in the future. I haven't heard anything here that gives any assurance that the existing problem cases won't develop into something more serious in the future.

Chairman **St Germain**. Have you heard anything here that would, as my question originally was, say to the public at large, we are no longer going to have these two types of institutions, the fail-safe and the failing?

Mr. **Carron**. I have heard some expresssions, some desire that we move in that direction, but nothing yet that I would feel comfortable with implementing to get us there.

Chairman **St Germain**. I appreciate the indulgence of the members. I don't know what your religion is. I am Catholic and we have the mystery of the Holy Trinity. We have been trying to solve it for hundreds of years. Do you think perhaps this fail-safe or failed banks' situation that exists today is trying to find a solution to eliminate the differentiation, and that it might be like trying to solve the mystery of the Holy Trinity?

Mr. SEXTON. Perhaps not quite as complex, Mr. Chairman. I do think though as long as we attempt to convey to the public that all banks can fail, I think we miss some credibility. I think the public doesn't believe that at all. A lot of us don't believe it, and that is what prompted me to make the suggestion that we entertain the idea of 100-percent insurance. That way, depositors in failed banks, one large, one small, get treated precisely the same, because we can't give them enough information to make their decisions about those banks. We have failed to do it so far and I think it is probably a goal that can't be achieved.

So we can't really tell the people enough to know where to put their money, and it seems quite inequitable to have a depositor in a failed small bank be differently treated from a depository in a failed bank that is large, and ergo, my suggestion that we entertain the idea of 100-percent deposit insurance in conjunction with the added or enhanced capital to keep banks from failing in the first place.

Chairman ST GERMAIN. Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

I am not Catholic and I am not into the mysteries of the Holy Trinity that much, so the analogy escapes me a little bit.

Chairman ST GERMAIN. Well, we are always trying to find proof. Let's go to Santa Claus. Is Santa——

Mr. KANE. As long as we don't try to explain the virgin birth, I think there is hope.

Mr. WYLIE. If you are talking about the Federal Government being Santa Claus, I think I can relate to that. I do think you have had good questions and informative answers here.

Professor Kane, in your statement, you say assuming that Congress is not ready to legislate a thorough overhaul, which you apparently recommend, and you do feel that there is a real crisis in the insurance program for depositing institutions. Is that a fair statement?

Mr. KANE. That is correct. My colleague, Mr. Carron, talked about the dilemma between availability and discipline. I think there is a dilemma in the short run, but attempts to avoid short-run instability by making ever more perfect the de facto or conjectural guarantees afforded large banks and large S&L's actually creates more instability in the long run. Whatever disturbances and disruptions we might experience from a limited number of failures in scattered periods of time would be nothing compared to the expense and devastation of a complete loss of confidence in the insurance system if one were to occur.

Mr. WYLIE. You say that you don't think we are going to do the thorough job that needs to be done but you recommend a second approach, and a key step to that would be to require market-value accounting, which you referred to earlier, for both insured institutions and the insuring agencies, and that this reform could lead to, as you put it, increased use of modified payoffs and increased agency disciplinary action.

Could you elaborate on what you mean by market-value accounting? I have listened intently, but I am not sure I understand it. Are you talking about something in terms like the inflation accounting recommendation of the Financial Accounting Standards Board or is it something different than that?

Mr. **Kane**. Thank you. It is different from inflation accounting. The notion is that every economic entity has a balance sheet and that each value entered there should be assessed at market prices. In trying to figure out what we have managed to save, you or I will usually look at assets such as stocks or bonds and ask what they sell for today. We won't claim that an asset is worth whatever we paid for it unless and until we actually sell it at a different price. Similarly, to value our house, we try to find out what we could sell it for today. We value assets at what we think these assets are really worth. We do the same thing for our liabilities.

Suppose we had outstanding an old mortgage, with a low interest rate of say 5 percent. We should recognize that our debt is worth less than its par value. On the other hand, if interest rates had fallen since we took on this debt, its market value would exceed par. Yet, all financial institutions are permitted—in fact, required—to value the debt and assets they hold at the prices they paid for them. They count acquisition cost as what an asset is worth until and unless either they sell it or examiners rule otherwise. This is why we hear, for instance, about the Bank of America seeking to improve its accounting net worth by selling appreciated real estate and leasing it back again. In selling its head office building in San Francisco and possibly its best buildings in Los Angeles while continuing to occupy them under very long leases, the bank's economic net worth hardly changes at all.

Accountants treat sales and leasebacks of appreciated assets as if they strengthen in a meaningful way the seller's balance sheet. But all a sale and leaseback does is to enable the seller to recognize the market value of assets formerly carried at acquisition cost. Other items on the balance sheet on which there may be large losses are not adjusted. A second part of my proposal is to insist that so-called off-balance-sheet items be entered on the balance sheet at experts' best estimates of what they are worth. The idea is that an institution should be as scrupulous in assessing its net worth as households are in assessing their own.

If we have outstanding leases, we would not ignore them in calculating our net worth. We would estimate whether or not they are going to prove a net source of value or source of losses to us over the future. We would take this value into account.

Another way to see the asymmetry is to note that when institutions want to lend us money on collateral, they don't care what you or I may have paid for collateral. They want to know what is it worth today?

Mr. **Wylie**. I am not into this as much as you are so I need some education on it. Switching to market value accounting, I am not sure who would determine exactly the market value of it. Would the market determine what the sale of the item is worth on the market.

Mr. **Kane**. This would be the appraisal principle. For nontraded and intangible assets, experts have to approximate the market. This is becoming easier and easier today, as more of the assets that banks hold have comparable quotes available in the market. A great many assets that never used to trade now trade in the form of collateralized securities. Such secondary markets give us an idea of what nontraded assets are worth.

For instance, automobile loans, computer leases, and mortgages of all kinds are being collateralized and sold indirectly. The prices of collateralized securities can be solved for the value of the underlying collaterial. Of course, some residual elements would be hard to price. There is room for an industry standard-setting board to decide how we should estimate franchise values and other intangibles. But, while not perfect, such an approach would vastly improve upon the system we have now. That system is too open to manipulation. Insurers need a more meaningful information system in which all values would be related to market value.

Mr. **Wylie**. It sounds complicated to me, Professor, I will have to tell you. Would it be very hard for institutions to institute this change? What about the thrifts, could they phase in the system today or tomorrow or how long would it take?

Mr. **Kane**. Well, I think you will find many of the best-run financial institutions in this country already use market-value accounting for internal purposes. It provides the best way to determine how well their firms are performing and to guide decisions about what projects and investments to pursue. Under a market-value system, Bank of America would not need to sell appreciated real estate to rebuild its capital account. This value would already be in its capital account. The problem with the current system is its asymmetry. One does not build accounting capital by selling things on which one has an unrealized loss.

Proponents of market-value accounting do not suppose that all values will be 100 percent accurate. But if appraisers try objectively to produce the best estimates of each item, their errors should tend to cancel out.

Chairman **St Germain**. You referred to the sale of one office building, for $600 million.

Mr. **Kane**. I don't know the figure. The FDIC could look to see at what value the firm has carried that building on its books.

Mr. **Silverberg**. Of course it is a national bank, but I am sure that figure is available. I personally don't know what it was. There was a very substantial capital gain in the transaction.

Chairman **St Germain**. I will ask the staff to look into that. Don't you think that it would be interesting for us to have that number to determine whether they were carrying it at the proper value?

Mr. **Kane**. If the bank were carrying it under the value proper for historical-cost accounting rules, it would begin with what it cost to buy the land and build the building. Then it would depreciate the building from the time it was finished. From the moment the bank occupied the building, given trends in real estate values in San Francisco, its market value began to appreciate above the book value. This is because depreciation was not related to the economics of using and owning this structure——

Mr. **Wylie**. Do you have any notion as to what the market value might have been, the increased market value might have been?

Mr. **Silverberg**. I do not.

Mr **Wylie**. Cost accounting.

Mr. **Kane**. If one were an expert in the San Francisco real estate market, one could track it pretty well. But I don't know the pattern of the year-to-year increases in comparable buildings. I would guess that it would be in excess of 10 percent per year in San Francisco over that period of time. They bank built its headquarters somewhere in the early seventies and began to occupy it around 1973 or so.

Mr. **Wylie**. What you are suggesting is that this would be a good way for depository institutions to increase their capital by going from this cost accounting method, which they now use, to this market value accounting method?

Mr. **Kane**. I wouldn't do this to increase their recorded capital, but to report a meaningful measure of what their capital is. Market-value calculations would include many items that are now neglected. These are called off-balance-sheet items. In the case of troubled institutions, one important off-balance-sheet items is value of Government guarantees. These belong on the books of insured institutions and of the deposit insurers themselves. The values of these guarantees explains why the stock shares of insured institutions sell far in excess of the difference between the market value of their bookable assets and liabilities. For S&L's at least, it is hard to attribute the difference of franchises values per se. Franchise values can't be high when there are obviously too many S&L's in existence. Their major resource is the value of the subsidized Federal guarantees that they enjoy. Once we record these values on the books as assets of the institutions, then we can go on to make these values the focus of future policy actions. Our goal should be to set up incentives for private capital to replace overtime the large amounts of Government capital now inherent in Federal deposit-insurance guarantees.

Mr. **Wylie**. You keep saying that, keep talking about taxpayer exposure, when you talk about risk-related insurance and the insurance program fund, FDIC, FSLIC, and the funds are now made up, of course, of assessments against the institution. Are you referring to the fact that we passed a resolution in Congress as far as the thrifts are concerned, merging the full faith and credit of the Federal Government, or what do you mean when you say taxpayer exposure?

Mr. **Kane**. Well, a March 1982 resolution puts the full faith and credit of the Congress of the United States behind the FDIC and FSLIC. But even deeper than that are the political forces that persuaded Congress to vote for that resolution at the time. These forces would tend to compel Congress and the President to support the insurance funds in any future crunch.

We can see these forces in the State-sponsored insurance systems that have failed in recent years. Political considerations stood out clearly in the Ohio case, in that the Governor and legislature desperately tried to push these costs of insolvency resolution onto the Federal taxpayer. I believe that one of the purposes of the Ohio banking holiday was to create enough disruption in national and international financial markets to make it attractive for Federal authorities to pick up the bill

Mr. WYLIE. OK. We had a front row seat on the State chartered S&L situation in Ohio, Mr. Kane, and you apparently do not agree with Mr. Carron that the private deposit insurance operation is impractical. I have the distinct feeling that the private insurance fund has outlived its usefulness as time has passed, but in your statement, you seem to indicate that there might be some sort of arrangement where the private insurer could be accommodated.

Mr. KANE. Well, the first point I would make is that in Ohio, we didn't experience the failure of a private insurance fund. What failed was a State-sponsored insurance fund, whose risk-management functions were performed by a Government agency that was not under the control of the insurance fund. The failure was a regulatory one. No private institution—no profitmaking institution—could afford to delegate its monitoring and risk-management controls to an independent third party.

As you know, the examiners for the State discovered the problem of inappropriate lending to E.S.M. Securities in 1982 when the amount was relatively small. Examiners brought this to the attention of top agency officials, who did not impose sufficient discipline on Home State managers to prevent the problem from growing over the following 3 years.

Mr. WYLIE. Do you have any examples of a successful private insurance fund? You say that the Ohio Deposit Guarantee Fund really wasn't a private fund, although the members made it up, and it was private. It wasn't guaranteed by either the Federal Government or State of Ohio. I agree with you that the State agencies increased their risk or increased their exposure.

Mr. KANE. The point I am trying to make is that a State-sponsored corporation is not a stockholder-owned corporation that faces pressure from its stockholders to protect their economic interests. ODGF-insured institutions were permitted to take risks that made no economic sense for anyone responsible for running the insurance fund——

Mr. WYLIE. Isn't there a strictly private insurance fund as an example right now?

Mr. KANE. A deposit insurer operating out of North Carolina is one. It doesn't use the name of its State in its title to suggest to depositors that the State stands in some way behind its guarantees. This fund has from the very beginning of the Ohio crisis taken a number of steps to adjust its business so as to reduce and to control its risk exposure during this difficult time.

Mr. WYLIE. The members have been before us asking for FSLIC insurance.

Mr. KANE. Yes, but this is at the urging of their insurer who is acting to preserve its solvency. It has recognized that private and State-sponsored firms can't do very well in the deposit-insurance business today because of the size of the implicit Federal subsidy available from the FDIC and FSLIC. In the present state of uncertainty, the firm can't compete effectively with a subsidized agency on these lines of business.

To reduce this subsidy, I would like to see Congress cut back the basic amount of Federal deposit insurance provided to individual accountholders and let additional layers of insurance be provided in a competitive framework between private firms and Government agencies.

Mr. **Wylie**. I will try to stick, and——

Mr. **Kane**. To provide additional explanation of market-value accounting, I prepared a chapter on the subject for an American Bankers Association task force. I can submit this chapter for the record if you would like.

Chairman **St Germain**. Without objection, it will be placed in the record at the conclusion of the question by Mr. Wylie.

[The chapter submitted by Professor Kane: "Chapter 8—Feasibility and Desirability of Permitting or Requiring Market Value Reporting for Financial Institutions," excerpt from a July 1985 report to the American Bankers Association follows:]

CHAPTER 8

FEASIBILITY AND DESIRABILITY OF PERMITTING OR REQUIRING MARKET-VALUE REPORTING FOR FINANCIAL INSTITUTIONS*

Accountants and economists both view the market value of a firm as the capitalized value of the firm's uncertain future profits. However, mainstream practitioners of the two professions disagree sharply in their approach to measuring profitability and to selecting an appropriate discount rate. Whereas the concepts implemented by contemporary accountants emphasize historical costs of a specific and concrete nature, economic analysis focuses on opportunity costs which are abstract in character and not directly observable.

Accountants seek to establish an information system that can deter the misuse of corporate resources, assist in coordinating the activity of a firm's employees, and conform to record-keeping and tax-paying requirements established by outside authorities (Benston, 1982). This leads them to concern themselves primarily with cataloging resources that are tangible in nature and registering obligations, expenditures, and receipts that occur in explicit and verifiable market transactions. Most other types of values and transactions may be described as unbookable under generally accepted accounting principles. In contrast, economists see no essential difference between sources of value that are bookable or unbookable, tangible or intangible, explicit or implicit.

Given the use an economist wants to make of information on cash flows, market-value accounting of total returns furnishes the appropriate measure of the

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*This paper was drafted by Edward J. Kane of Ohio State University as part of a larger July 1985 consultants' report to the American Bankers Association on the safety and soundness of U.S. banking institutions. The other consultants were George Benston, Robert Eisenbeis, Paul Horvitz, and George Kaufman. Although they offered valuable criticism of earlier drafts, neither the American Bankers Association nor the four other consultants should be construed to hold the position expressed in this document.

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performance of a firm and historical-cost accounting values provide misleading measures of the magnitude, timing, and origins of firm income. The following examples illustrate how interest volatility distorts accounting measures of bank earnings and net worth when financial assets are carried at historical cost and records of implicit forms of income and expenses are not recorded with economic sensitivity.

On a bank's continuing holdings of loans and investments, historical-cost accounting records interest income only. It does this even at times when fluctuations in interest rates subsequent to acquisition induce substantial amounts of observable (though unrealized) appreciation or depreciation in the value of these assets. Such unrealized capital gains and losses are reported, but not at the time they occur. Rather they are impounded into above-market or below-market accounting returns that the misvalued assets generate throughout the period in which they remain in the bank's possession. To illustrate, we may suppose that the yield on a 10-year $100 bond purchased at par rises from 10.0 to 10.5 percent. If an institution marks its portfolio to market, it books an immediate capital loss equal to the decline in the market price of the bond. This price decline occurs to permit the bond to earn the market yield of 10.5 percent over its remaining life. If the institution continues to record the bond at par, it effectively amortizes the bond's decline in market value by recording future returns on this investment at the below-market rate of 10 percent. The difference between the 10.5 market interest rate and the coupon rate of 10 percent reflects the gradual realization of the unrecorded capital loss.

Changes in market interest rates similarly distort liability values. Recording core deposits and outstanding certificates of deposit at par neglects interest-induced gains and losses in these liabilities that, when properly conceived, serve to reduce the net impact of fluctuations in the market value of bank assets. A related distortion occurs because implicit interest that banks pay to depositors in the form of advantageously priced account services are typically recorded as noninterest operating expense. If core deposits were valued at market, implicit interest expense would have to be allocated across account types to permit an accurate comparison of total returns received by accountholders with market rates of interest on other types of funding.

Financial analysts seek to bridge the gap between accounting reports and economic values. They routinely estimate unrealized charges against a bank's reported capital position, using (among other data) differences between market and accounting yields. Their detective work helps to explain why empirical evidence supports the hypothesis that eventually (i.e., after making allowance for recognition lags) stock markets penetrate the veil of historical-cost accounting to estimate total returns (Hagerman, 1975; Sachs and Kyle, 1985). Now that call-reporting procedures require banks to disclose the amount of market-price depreciation in selected assets, in the future financial analysts and bank regulators should be able to produce more timely estimates of the market value of bank capital accounts.

Arguments For and Against Mandating Greater Disclosure

Benston (1979) emphasizes the difficulty of establishing that mandated publication of accounting data ever proves of net benefit to society. A key point in his argument is that in competitive securities markets managers face strong incentives to disclose and communicate useful information to investors. Benston also stresses the inappropriateness of expecting mandated disclosures to prevent determinedly dishonest managers from making false and misleading financial reports to the public.

What makes the situation of insured deposit institutions different is that the penalties they need most to worry about are not determined in competitive markets. They are set by regulators whose information system focuses on judgments by examiners whose rapid average turnover assures uneven skills and experience. An examiner's job is the difficult one of ferreting out evidence on managerial dishonesty or incompetence and on the extent to which deposit-institution managers succeed in exploiting deposit-insurance subsidies to risk-taking. To the extent that all managers can increase the flow of expected subsidies if they make it hard for examiners to monitor their behavior, a common industry interest develops in limiting voluntary public disclosure and in negotiating additional private disclosures with important stockholders and uninsured creditors. Moreover, because regulatory-agency heads typically have short horizons, agencies may naturally favor reporting systems that retard the release of information unpleasant enough to compel them to take unpopular actions. However, because disclosure limitations suppress clues that could help auditors and financial analysts to detect fraud and mismanagement, they make it possible for dishonest and incompetent deposit institution managers to survive longer than they could otherwise. In an era in which interest-rate volatility and specific classes of loan losses have differentially undermined the net worth of different deposit institutions, the distribution of the benefits from nondisclosure may well have become skewed toward high-flying and loosely managed firms.

Whatever information managers choose to disclose selectively and to whom, financial institutions ought to use market-value records in their internal information systems. Such information should help managers to see their operations as savvy regulators and stockholders ought to see them and to reassess traditional portfolio practices whose effectiveness may have been undermined by the surge in interest volatility created by the October 6, 1979 shift in Federal Reserve procedures and priorities for monetary control. Probably the chief example of a maladapted portfolio practice is the policy of buying and holding long-term securities as a liquidity reserve. Although many bankers object that the potentially deleterious effects that market-value reporting would have on returns earned on long-term bonds over short accounting periods would force them to seek liquidity only in short-term securities, it is hard to treat this as a logical drawback of market-value accounting. When examined carefully, portfolio policies that seem undesirable under market-value accounting ought to be undesirable under historical-cost accounting as well. A bank that would buy fewer intermediate or long governments if it had to account for them at market value ought to hold fewer of these securities even under the current system. Permitting bankers to control the time at which capital gains and losses are recognized lets them defer some taxes, but being able to time the recognition of important classes of losses cannot markedly reduce the risks to which a bank's capital (and therefore its stock price) is ultimately exposed. Moreover, a bank's use of market-value accounting for purposes of internal information and external reporting would not affect its tax liabilities, which must be computed from historical-cost records.

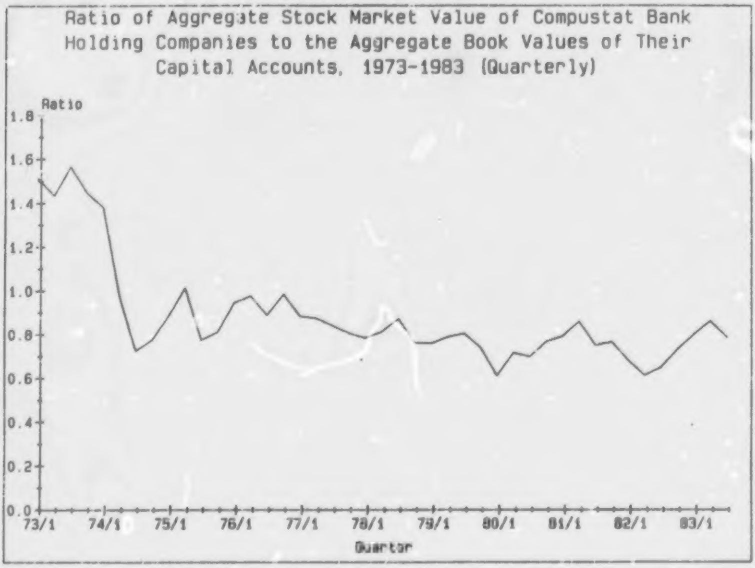
Whether timely information on total returns (where total returns are given by earnings statements that adjust explicit income for changes in portfolio market values) is too sensitive to disclose to various groups of outsiders is a more controversial issue. It is fair to say that, during most of the last 20 years, the banking industry has determinedly resisted proposals by the SEC and FASB to require more meaningful accounting for bank balance sheets and earnings statements. Besides trying to reduce regulatory interference in deposit-institution operations, industry resistance to market-value reporting reflects concern about the technical difficulty of estimating meaningful market prices for nontraded assets and liabilities (including intangibles).

Current fears about disclosing unrealized losses are aggravated by the accumulation of unfavorable shocks that the industry has had to weather during this era, although this is primarily a problem of managing the transition from one reporting system to another. As Figures 1 and 2 show for bank holding companies whose conditions are tracked by the Compustat data service (identified in Table 1), since 1973 these shocks have driven the market values of capital accounts at the average reporting bank cumulatively well below book values. At savings and loan associations and mutual savings banks, the decline is even sharper (Kane, 1985).

No matter how much individual managers might want to move their institutions toward market-value accounting in the long run, large amounts of unrealized losses on investments and problem loans predispose them at this time to let sleeping dogs lie. Threatening times seem poor occasions either to inform regulators about the true size of market-value losses or to put to an additional empirical test academic economists' beloved hypothesis that deposit and stock markets have already discounted whatever unpublicized information is unfavorable to their banks. Maintaining traditional standards of secrecy appears instead to be the very soul of managerial discretion.

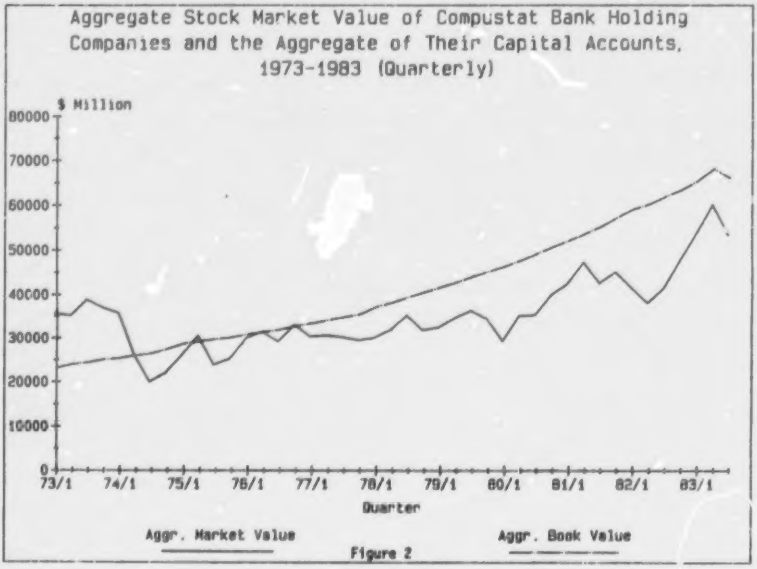
However, waiting for banks to find a propitious time in the interest-rate cycle to make the transition to market-value accounting may bear more than a minor resemblance to waiting for a myopic homeowner to find an ideal time to insulate his attic. In the summer, it is too hot to work under the roof; in the winter, it is too cold. During the fall and winter, he sees no need for insulation at all.

Transitional and continuing costs might be minimized by taking a permissive approach, authorizing individual institutions to switch to market-value accounting at their own option. Supporters of this approach would draw a careful distinction



Ratio of Aggregate Stock Market Value of Compustat Bank Holding Companies to the Aggregate Book Values of Their Capital Accounts, 1973-1983 (Quarterly)

Figure 1



Aggregate Stock Market Value of Compustat Bank Holding Companies and the Aggregate of Their Capital Accounts, 1973-1983 (Quarterly)

Figure 2

Table 1

List of Companies Included in Bank Compustat File on August 18, 1983

Affiliated Bankshares Colo
Allied Bancshares Inc
American Fletcher Corp
American Security Corp
Ameritrust Corp
Amsouth Bancorporation
Arizona Bancwest Corp
Atlantic Bancorp
Banc One Corp
Bancal Tri-State Corp
Banco Popular De Puerto Rico
BancOhio Corp
Bancorp Hawaii Inc
Bank of Boston Corp
Bank of Commonwealth-Detroit
Bank New England Corp
Bank of New York Co Inc
Bank of Virginia Co
BankAmerica Corp
Bankers Trust New York Corp
Banks of Iowa
Barnett Banks of Florida
Baybanks Inc
CBT Corp
Centerre Bancorporation
Central Bancorporation Inc
Centran Corp
Chartercorp
Chase Manhattan Corp
Chemical New York Corp
Citicorp
Citizens & South Ga Corp
Colorado Natl Bankshares
Comerica Inc
Commerce Bankshares Inc
Commerce Union Corp
Continental Bancorp-Pa
Continental Illinois Corp
Corestates Financial Corp
Crocker National Corp
Cullen/Frost Bankers Inc
Deposit Guaranty Corp
Dominion Bankshares Corp
Equimark Corp
Equitable Bankcorporation
Fidel-Cor
Fideltiy Union Bankcorp
First & Merchants
First Alabama Bancshares Inc
First Atlanta Corp
Fist Bank System Inc
First Chicago Corp
First City Bancorp (Texas)
First Empire State Corp
First Florida Banks Inc
First Hawaiian Inc
First Interstate Bancorp
First Kentucky National
First Maryland Bancorp
First Natl Cincinnati Corp
First Natl State Bancorp
First Oklahoma Bancorp
First Pennsylvania Corp
First Security Corp-Del
First Tennessee Natl Corp
First Union Corp (N.C.)
First Virginia Banks Inc
First Wisconsin Corp
Flagship Banks
Fleet-Financial Group Inc
Florida Natl Banks of Fla
General Bancshares
Greater Jersey Bancorp
Harris Bankcorp Inc
Hartford National Corp
Heritage Bancorp
Huntington Bancshares
Indiana National Corp
Industrial Valley Bk & Trust
Interfirst Corp
Intrawest Finl Corp
Irving Bank Corp
Key Banks Inc
Liberty National Corp
Lincoln First Banks
Manufacturers Hanover Corp
Manufacturers National Corp
Marine Corp
Marine Midland Banks
Marshall & Ilsley Corp
Maryland National Corp
Mellon National Corp
Mercantile Bancorporation
Mercantile Texas Corp
Michigan National Corp
Midlantic Banks Inc
Moore Financial Group Inc
Morgan (J.P.) & Co
NCNB Corp
NBD Bancorp Inc
National City Corp
Norstar Bancorp Inc
Northern Trust Corp
Northwestern Financial Corp
Norwest Corp
Old Kent Financial Corp
PNC Financial Corp
RIHT Financial Corp
Rainer Bancorporation
Republic New York Corp
Republicbank Corp
Riggs Natl Corp Wash. D.C.
Security Pacific Corp
Shawmut Corp
Society Corp
South Carolina Natl Corp
Southeast Banking Corp
Southwest Bancshares
State Street Boston Corp
Sun Banks Inc
Sunwest Finl Services Inc
Texas American Bancshares
Texas Commerce Bancshares
Third National Corp
Trust Company of Georgia
Union Natl Corp-Pennsylvania
Union Planters Corp
United Banks of Colorado
United Jersey Banks
United Missouri Bancshares
U.S. Bancorp
U.S. Trust Corp
United Virginia Bankshares
Valley National Corp Arizona
Virginia Natl Bankshares
Wachovia Corp
Wells Fargo & Co
Zions Utah Bancorp

Source: Standard & Poor's Compustat Services, Inc.

between market-value accounting and required addendum reporting of changes in the market value of selected assets. Market-value accounting implies a double-entry system of market-value records. Market-value reporting focuses on requiring market-value reports of material facts at least to regulators. A voluntary approach would leave managers free to choose whether and when market-value accounting should take hold at their institution, granting firms for which the transition seems particularly difficult a breathing space in which to restructure their balance sheets to smooth the passage. However, if strong institutions find it advantageous to use market-value accounting to signal their financial vigor to depositors and subordinated debtholders, weaker firms would probably feel market pressure to adopt it, too.

An additional fear is that, in situations where a bank's survival is threatened, market-value accounting might tend to deteriorate into fire-sale accounting. At an institution's most perilous moments, accountants' and examiners' disposition to protect themselves against hind-sighted criticism could lead them to pressure banks into understating the current going-concern values of problem loans and investments. Whereas the clients of financial analysts are apt to criticize them as severely for undervaluing as for overvaluing a bank's stock, regulators and accountants are apt to suffer more from overstating a bank's financial condition than for understating it. Even though auditors who place their own interests ahead of their clients are apt to lose business in the long run, their first concern is to minimize their own liability to civil action in the event of client-bank failures. This makes them reluctant to assign sufficient value to concessions and operational adjustments made by troubled borrowers during the work-out process. Any banker who decides to implement the principle of honest accounting for hidden losses is bound to open up new fronts of warfare with faint-hearted auditors and examiners.

The other side of the picture is that the sensitivity of bank stock prices and deposit flows to bad news is heightened by the absence of reliable data both on the dollar size of particular shocks and on individual institutions' capacity to absorb unfavorable shocks of different sizes and types. The absence of adequate regular disclosure of the value of unrealized charges against bank capital makes it reasonable for uninsured depositors and noninsider stockholders to seek private disclosures, demand informational risk premiums, and be prepared to run for cover at the first signs of heavy weather.

In not facing up to this problem, industry strategists suffer from what we might term the "cosmetics fallacy." The knowledge that wearing thick pancake make-up hides a wearer's facial blemishes from direct view doesn't justify the hypothesis that intelligent observers must assume that the wearer's unseen blemishes are minimal. Wearing heavy make-up signals one's unwillingness to show an untouched-up face to the world. Depositors and investors assume that an institution resorts to make-up precisely because some aspects of its complexion are ugly enough to conceal. Although trade-association efforts to sidetrack regulatory proposals that would make banks disclose their hidden losses are beginning to relent, past efforts deepened the suspicion that a bad complexion may be an industry-wide phenomenon rather than an isolated problem.

By making it easier for the FSLIC insurance fund to slip seriously under water (Kane, 1985), cosmetic accounting has hurt deposit institutions in an even subtler way. It has exposed them to a greater risk of having to pay ex post for the excesses of their highest-flying competitors. To rebuild FSLIC reserves that have been devastated by past S&L failures, federally insured S&Ls have been asked to pay supplementary assessments of 1/32 of one percent of their deposits each quarter in 1985. If additional failures should render S&L resources too small a tax base, Congress is likely to merge the FSLIC into the FDIC. This means that the extent of S&L insolvencies threatens to spill over onto the books of the commercial-banking industry.

Market sensitivity to the extent of cosmetic accounting leads Kane (1983), among others, to conclude that the short-term interests of all but the nation's weakest deposit institutions and the long-term interests of the industry as a whole now lie in the direction of regular and adequate disclosure of the income and balance-sheet consequences of favorable and unfavorable economic events. If informational risk associated with growing and unresolved insolvencies is depressing the stock prices of strong and weak banks alike, the major beneficiaries of shifting to market-value accounting may turn out to be executives who hold stock option positions in healthy banks. To paraphrase Franklin Roosevelt, except at the weakest institutions, managers may have nothing to fear so much as the fear of market-value accounting itself. To protect themselves against being stung directly or indirectly by unobservable bad investments of the types that have recently come to light at the industry's worst problem banks, suppliers of capital and of uninsured deposits may currently penalize many well-capitalized banks by exacting informational risk premiums that drive a bank's stock price lower and its CD rates higher. Even in times that are less troubled than the present, because a bank's power to shop for more flexible auditors gives it some leverage in debating its asset values with squeamish accountants, investors' and creditors' fear of surprises lead them to discount bank stock and uninsured bank debt to compensate them for the industry's insistence on maintaining the right to report capital gains and losses in its own way and in its own time. Along with the market's need to correct for bankers' tendency to overstate their own earnings, the opportunity cost paid for deposit-insurance authorities' ability to postpone the resolution of their own insolvency problems helps to explain the traditionally low price-earning multiples observed for bank stock.

It is unlikely that it currently serves the self-interest of soundly managed banks to assist their loosely managed competitors to cover up the extent of their relative weakness. In a free society it is hard to see why a bank should not be given the right to disclose any valid information relating to its economic condition that its managers deem useful to stockholders and uninsured creditors.

Nor is it reasonable to maintain that disclosing the unvarnished truth about problem institutions could provoke a financial panic that might engulf the banking system as whole. Such an argument overlooks the recent willingness of the Fed to act as lender of last resort to failing banks and S&Ls and of the FDIC and FSLIC to husband their explicit deposit insurance reserves by assisting troubled firms on generous terms, a willingness that we have explained and documented in previous chapters. Institutions depend, not on customer confidence that accounting reports will alert the public to serious problems before the value of their deposit holdings can be jeopardized, but on customer confidence in the Fed and state and federal deposit insurers to resolve economic insolvencies in ways that keep insured creditors whole and (to eliminate the threat of contagious runs) typically rescue uninsured ones as well.

The industry's fight against applying principles of current-value accounting to such obvious losses as those in LDC loans and low-interest mortgages has mixed benefits. Because book-value accounting encourages regulators to postpone actions that could resolve major economic insolvencies at thrift institutions and problem banks before they become major, it makes the investing public more suspicious of the entire industry.

Benefits and Costs of Market-Value Reports

Bankers need to recognize that if they don't take action to limit unintended subsidies to deposit-institution risk-bearing, regulators will do it for them. By substituting market for regulatory discipline, market-value accounting and even regulatory disclosure lessen the industry's exposure to arbitrary changes in the burden of regulation. Because market-value accounting threatens to expose regulators as well as bankers to more effective outside criticism, it would force agency heads to make the criteria used by bank examiners less subjective and to develop procedures for reducing variation in the toughness of examinations both from one examiner to another and across different stages of the business cycle. Evidence exists that variation across banks in the ratio of substandard loans to total loans is importantly impacted by variation in examination agency methods and individual examiners' biases (Benston and Marlin, 1974).

Market-Value Accounting As a Form of Risk-Rated Premium

An important source of many regulatory difficulties is that a deposit institution's managers have more and better information about the riskiness of their firm's operations than its insurers and customers have. In 1938, generally accepted accounting principles and regulator-imposed accounting rules made it easier to keep outsiders in the dark by authorizing deposit institutions to employ what is misleadingly called intrinsic-value accounting. Intrinsic-value accounting permits assets whose scheduled cash flows are relatively current to be carried on the lender's books at historical cost, even when the borrower's economic prospects have deteriorated sharply. Contemporary accounting principles relieve managers who report book values (and absolves their outside accountants as well) from legal liability for communicating less than their best estimate of the value of an institution's portfolio. Legal authority to use book-value accounting to cover up adverse information gives a financial-institution manager (especially an unscrupulous one) too much discretion over the extent to which current problems show up on an institution's income statement and balance sheet.

At least with respect to the particular subset of individual deposit institutions for which valuing intangibles and nontraded assets raises few problems in implementation (a class which should include most thrifts), instituting market-value accounting for loans and investments can be justified as an administratively cheap scheme for raising the firm's implicit regulatory premium on deposit insurance in a risk-sensitive way. This is because the opportunity cost of having to report the market value of these assets tends to rise with an institution's exposure to capital losses.

The most attractive aspect of adopting a market-value approach is that by better focusing traditional capital requirements and other implicit premiums, it would make regulatory discipline more effective. Using market values would permit market forces to help bureaucrats conduct their ongoing assessments of an institution's risk exposure and develop appropriate penalties for overly aggressive risk takers (Kane, 1983).

Deposit-institution regulators increase an institution's capital requirements with the level of their assessment of the institution's risk exposure. This means that capital requirements are intended to function as risk-rated implicit premiums designed to choke off the subsidy to risk-taking inherent in the risk-insensitive structure of the explicit premiums deposit insurers are required to charge. At the same time, the traditional approach to financial accounting gives bank regulators and bank managers considerable discretion over what items are and are not currently recorded as capital. The root problem is that accountants designate several important sources of value as unbookable: e.g., loan commitments, credit guarantees, opportunities to engage in fee-for-service business, and unrealized increases and decreases in the market value of assets and liabilities. By undertaking appropriate transactions, the manipulative manager may lessen the impact of capital requirements by systematically overstating the value of his or her firm's capital account. This is accomplished by deferring unbooked losses and realizing unbooked capital gains (e.g., by arranging sale-and-leaseback transactions or selling fee-for-service business to an affiliated or subsidiary firm).

In a world where declines in market value are not obscured by book-value (i.e., historical-cost) accounting, deposit-institution managers who contemplate aggressively pursuing unregulated risks would know that they would have to defend their risk-taking strategies against more timely regulator and financial-analyst criticism and to offer correspondingly higher interest rates more quickly to any depositors who perceive themselves to be truly uninsured. This means that, when and if these risks go awry, managers would face quicker and more extensive damage to their careers and to the stock price and deposit flows of the institution they manage.

Managerial discretion over the release of unfavorable information puts the burden of valuing deposit institutions on financial analysts and weakens political controls that would otherwise discipline institutions' and insurers' risk exposure. It may also delay the effect of market discipline. Losing the right to touch up and string out the unfolding implications of unfavorable news should make managers more responsive to the interest of insurers and uninsured depositors when they are facing potentially injurious developments. This increased sensitivity establishes incentives for deposit-institution managers to modify and to bond their behavior in helpful ways. The May 1984 crisis at Continental Illinois can be interpreted as a growing and lagged recognition that the bank's unrealized losses may have exceeded its capital. Even in the face of explicit FDIC guarantees of all

Continental Illinois liabilities, depositor reaction was severe. In particular, responding to their exposure to hind-sighted criticism under prudent-man rules, institutional investors insisted on substantially reducing their positions in the bank.

If private parties are to bear more of the risk inherent in de jure and de facto failures, we must expect regulators, deposit institution investors, and uninsured depositors to ask managers to give and accountants to attest to a best-efforts estimate of the risk exposure and changing market value of the assets and liabilities that deposit institutions hold on their books. To protect the interests of federal taxpayers and healthy institutions in the insurance pools, deposit insurers need to press for reliable information on the value of unrealized losses and gains at financial institutions, information of the sort that conscientious deposit-institution managers should be assembling and analyzing in the course of operating their firms.

Technical Difficulties of Market-Value Accounting

In an era of interest volatility, to produce estimates that would be more accurate than historical costs accountants need only to insist that deterioration in borrowers' repayment capacity be recognized as quickly as management becomes aware of it and to supplement their traditional auditing skills by developing and deploying a solid competence in financial asset appraisal. Much as in real-estate appraisal, to value an asset that does not trade, an analyst must rely heavily on projections of a borrower's earning capacity and on current yields and prices in secondary markets for comparable investments. For an institution as a whole, as long as unbiased appraisal techniques are employed, errors in valuing the individual assets in its portfolio should tend to cancel out. Of course, establishing that in specific cases a particular accountant did, in fact, employ unbiased appraisal techniques can be a difficult and litigious problem. The required reorientation of professional effort and legal burdens of proof helps to explain accountants' reluctance to support a switch to market-value accounting for financial institutions.

To estimate the value of fixed assets, mortgages and directly placed loans (such as those to troubled farmers, energy firms and less-developed countries), the major problem is to assess the reliability of lender projections of future cash flows and to obtain appropriate estimates of market discount rates to use as inputs into present-value formulas. Practical use of these formulas has been trivialized by software that preprograms the necessary calculations onto floppy discs or hard-wires them into the circuits of hand-held calculators. Obtaining reliable numbers to key into the calculations is where skill must be exercised.

If federal deposit insurers wanted to develop rather than to conceal such information, they could expand the set of transactions observed in secondary markets. Specifically, they could request their liquidation divisions to arrange for periodic auctions of assets chosen for their inherent comparability to the most important classes of hard-to-value instruments currently being held by troubled institutions.

Until very recently, neither banking regulators nor the deposit-institution industry has wanted to publicize such base-line values. Although we may cite some tentative administrative steps in the direction of greater disclosure, backsliding continues to occur with respect to risks that are politically protected. On the plus side, authorities have required banks to report their positions in troubled foreign loans and required S&Ls to report gaps between the interest sensitivity of their assets and liabilities. In 1982-83, the FHLBB explored very seriously a proposal to require FSLIC-insured S&Ls to adopt market-value accounting (U.S. Federal Home Loan Bank Board, 1982 and 1983). In 1984, the SEC (which has continually pressed for improved disclosure) and the Office of the Comptroller of the Currency pointedly forced several large institutions to restate their 1983-84 profits in a less self-serving manner. However, authorities have encouraged cosmetic accounting by permitting problem loans to less-developed countries to be carried at book value and by promising to take a "flexible" approach to valuing distressed farm loans at banks located in agricultural regions.

Liabilities such as contingent guarantees, intangible assets, and reputational values pose more difficult valuation problems. Such problems might be resolved most expeditiously and most equitably by assigning the tasks of identifying currently unbookable sources of value and determining valuation principles and procedures to a self-regulatory industry board.

Opponents of disclosing market values cite two drawbacks: first, the costs of providing market appraisals might exceed the benefits and, second, outside parties might dangerously misinterpret the accounting reports that result. One cost is that, to the extent that estimating market values is inherently less objective and reproducible than the process of recording historical acquisition costs, opportunities for exaggerating or concealing economic income are expanded. Because auditors and government examiners would have to check reported figures more carefully than ever, the projected cost and complexity of outside audits and governmental monitoring would increase. One offsetting benefit is that making changes in bank portfolio values public creates incentives for managers to adopt policies that make the true value of income fluctuations smaller. Other offsetting benefits are ethically more defensible standards for truth-telling in accounting, improved decisionmaking at any firm whose internal information system does not already employ market-value data, and a potential reduction in the size of informational risk allowances that market participants demand to compensate them for the uncertain cosmetic nature of bank accounting reports.

The issue of misinterpretation focuses on the likelihood of increased fluctuations in reported earnings under market-value accounting. Economic analysis suggests that, if it weren't for the blunting of incentives by the deposit-insurance subsidy, many deposit institutions would have moved to market-value accounting soon after increased interest volatility significantly impaired the ability of historical-cost accounting to track bank portfolio values and economic profits.

Finally, it should be noted that the net costs of producing market-value estimates would be less than their direct costs, because similar analysis is already being performed by others. By simplifying the tasks of financial analysis and of deposit-insitution examination, market-value accounting promises to free up resources employed elsewhere in the financial industry.

Regulatory Benefits

On the regulatory side, if federal taxpayers were well-informed, political pressure would have led Congress to insist that deposit insurers require market-value reports long ago. Such information would help regulators to discover and to resolve problem situations more quickly and generate popular pressure on authorities to make more timely and better focused interventions.

Because legal insolvency differs from economic insolvency, a market-value reporting system would not take the failure decision out of governmental hands. As long as deposit-insurance agencies remain free to offer capital assistance to failing clients, market-value accounting would merely curtail rather than eliminate regulatory discretion as to whether and when to close an economically insolvent institution. However, by forcing more timely and more explicit forms of intervention, market-value accounting would reduce an insolvent institution's opportunities for pursuing go-for-broke strategies.

Spokespersons for financial institutions whose portfolio book values mask market-value insolvency promote the sunny, though dangerously false view that unrealized losses are less harmful to society than realized ones. However, the main difference between the two types of losses lies in the incentives they generate. In realizing a loss the institution publicly acknowledges its effect and takes out of its portfolio the continuing risks associated with the investment that generated the loss. When past net losses remain unrealized, the effect remains hidden and the investments that generated the losses stay in the portfolio to grow or decline in the future. Because unanticipated gains tend to accrue in greater proportion to stockholders while unanticipated losses tend to accrue disproportionately to government guarantors, it is inappropriate for regulators to employ an accounting scheme that neglects the impact that unrealized losses have on an institution's capital position and risk-taking incentives.

Accounting standards that make it possible for individual deposit institutions to disguise insolvency and risk-taking beyond all recognition without violating the law make a mockery of existing capital requirements. Until these standards are changed, the effects of proposals to solve the deposit insurance problem by raising or restructuring deposit-institution capital requirements may be extensively blunted.

Disclosure of Administrative Actions

Public embarrassment can reinforce the career risk to which subsidy-maximizing managers are exposed. For this reason, critics have urged that periodic bank examination ratings be made public.

In a precedent-setting case, the FDIC released in February 1985 the names of persons it fined in connection with the failure of a small Tennessee bank and publicly identified the money brokers who had placed funds in the bank before it failed. In May 1985, the FDIC announced that henceforth it would release each week the names of banks and bank employees against whom it has obtained cease-and-desist orders, removals of directors and officers, or civil penalties. It will also disclose the termination of FDIC insurance at any bank. While these disclosures do not occur until FDIC enforcement proceedings have been concluded, the FDIC has threatened to open its administrative hearings to the public and has reserved the right to expand its disclosures to include notice even as to the initial bringing of charges against an insured institution.

When agency actions are well-founded, general or selective disclosure of regulatory sanctions is a weapon that promises to increase the penalties that uninsured creditors impose on banks that engage in unsound banking practices. The problem is that agency criticisms are not always well-founded. Bankers fear that capital markets may overreact to negative publicity generated by adverse, but ill-conceived criticisms of their business policies. This fear makes the threat of disclosure a device that strengthens the capacity of federal regulators to persuade banks to adopt the practices and balance-sheet structures they recommend.

Nevertheless, overreaction should not be the market's typical response. Regulatory reversals won in appellate courts and ordinary citizens' experience with the arbitrariness of government bureaucracy provide evidence that regulators frequently make mistakes. Although it is costly to defend managerial practices against regulatory attack, bankers should not assume that their customers are unwilling to listen sympathetically. Because of such explanations, Ohio's six uninsured S&Ls prospered in the aftermath of the state-imposed 1985 banking holiday that undermined confidence in roughly 70 S&Ls whose deposits had previously been insured by a state-sponsored fund. Publicity over unfounded regulatory criticism can even redound to a bank's net advantage by calling regional and national attention to creative and tough ways in which it has conducted its affairs.

Moreover, bankers and uninsured creditors should recognize that disclosure is a two-edged sword. When regulatory actions must be debated in the open, regulators have a strong incentive to double-check the theories, facts, and circumstance on which their objections are based. As regulators come to appreciate the bureaucratic penalties that the political system imposes on agencies that act high-handedly, the frequency of arbitrary action should fall.

Costs and Benefits of Switching to Market-Value Accounting Varies with a Bank's Complexity and Information System

This section discusses the feasibility of valuing the capital of different kinds of banks (as well as the contribution to capital generated by any particular subportfolio) as the net difference between the market value of all of its assets and liabilities. Market-value accounting is feasible as long as data on scheduled cash flows and associated customer timing options can be combined with interest rates and asset prices from secondary markets for comparable instruments. As the computerization movement matures and as investment-banking firms extend the range of instruments whose cash flows they strip and package for resale in derivative instruments such as CMOs (collateralized mortgage obligations) and CARs (collateralized automobile receipts), the task of appraising the market value of institutional portfolios will become progressively easier and more precise. Where comparable secondary markets for nontraded assets have not yet developed, regulators could facilitate the use of market-value accounting by arranging periodic auctions of instruments selected to produce data suitable for appraising other categories of assets and liabilities.

Top managers of many large depository institutions and insurance companies regularly review market-value records. To assist them, at least one firm (BARRA of Berkeley, California) has developed a bond valuation service. The firm's promotional literature claims that their model isolates the important characteristics of 15,000 government and corporate bonds and 60,000 GNMA pools and estimates daily market values for these characteristics. By extrapolating the daily values assigned to analogous characteristcs for private placements and bank loans, any institution's portfolio can be revalued daily. While these estimates must be recognized as accurate only to within a few cents on the dollar, it is clear that in an era of volatile interest rates on average such figures would more closely approximate the true value of a representative deposit institution than would measures of the firm's traditional book value.

Large banks are distinguished from small banks primarily by the complexity of their affairs, by their higher percentage of uninsured and interbank liabilities, and in the event of their insolvency by the FDIC's greater difficulty in locating and negotiating with suitable acquirers. For large and small banks alike, the internal advantages of assembling market-value information are great. The problem comes in deciding how much of this information to report to what parties and whether to install a full-fledged market-value accounting system. To specialized institutions, the prospective costs of installing a market-value accounting system reduce to the trouble of establishing and maintaining a system for tracking changes in the market value of only a few assets and liabilities. Apart from the trouble of re-educating managers and reorienting their activities, the transition and continuing costs of adopting a market-value accounting system are more a function of portfolio diversity than of institutional size. To insurers, market-value reporting promises to prove most beneficial for the firms that currently profess to fear it the most.

To take account of transitional costs that trace to differences in the size and complexity of different institutions, the switch to market-value reporting could be phased in gradually over time. One approach would be to set different phase-in deadlines for different kinds of banks based on the extent to which market-value reports are already used for internal purpose. On this criterion, money-market banks and those with a large correspondent business could be required to make the change first, followed by other large banks (particularly those whose holding companies are publicly held). Managing the speed of transition is essentially a matter of reading and responding to political counterpressures. Decisionmakers must balance the benefits from improving the flow of information to insurers and uninsured creditors against the temporary disruptions installing the new system might cause managers and stockholders in various institutions.

The most serious technical problem concerns the difficulty of identifying and appraising intangible assets and off-balance-sheet sources of value. Cosmetically minded bank managements would have an incentive to acknowledge and to overestimate all positive sources of value (such as opportunities to earn fee income) and to neglect and underestimate negative sources of value (such as standby guarantees and loan commitments). To counter these biases, even if only selective market-value reporting is established, objective standards must be established. Because financial market opportunities are changing so fast, it seems appropriate to assign the proactive task of standards-setting to a banking-industry self-regulatory board rather than to inherently less well-informed parties at the Financial Accounting Standards Board or the federal agencies. Such an institution's interest in minimizing inequities in the distribution of net deposit-insurance benefits should make the institution of market-value reporting more palatable politically. The board's task would be to enunciate general principles, to determine what items should be reported or disclosed, and to act as either an appeals board or an arbiter in settling disputes between institutions, their accountants, and their insurers. Representation on this board should include financial-institution managers, practicing and academic accountants, experts in asset appraisal, regulators, and academic economists.

Summary

Deposit-insurance reform should aim not at preventing future bank failures *per se*, but at preventing the subsidization of bank risk-taking at all times. Given that federal deposit insurance systematically subsidizes any form of risk-taking that the FDIC does not administratively penalize, to control risk-taking over the long run it is necessary to unblock opportunities for banks to fail (including very large banks). Economic analysis suggests that it is possible to reduce *de facto* bank failures in the long run by making it more likely in the short run that market forces will punish stockholders and managers for risk-taking that goes awry.

Permitting or mandating market-value reporting is a relatively low-cost way of improving market discipline. Currently, market incentives for and against voluntarily disclosing changes in market values vary with the size and other characteristics of individual banks. For widely held institutions, stock prices already provide ongoing market-value estimates of firm net worth. Moreover, even at privately held and mutual firms, important depositors and creditors are often able to force disclosure to themselves of parallel information. In contrast, the rapid turnover of the heads of regulatory agencies disposes them to prefer reporting systems that can delay the release of unpleasant news until after their term of duty has expired. Given that the burden of financing the deposit-insurance subsidy falls disproportionately on federal taxpayers and conservatively managed deposit institutions, the public has an important stake in the disclosure issue.

An accounting presentation is deceptive if it leads its audience to form an erroneous impression of important values. Whether or not bankers or regulators actually intend to deceive anyone, many of them have been less than forthright in acknowledging the impact that off-balance-sheet items have on the adequacy of bank capital and in writing down the value of impaired assets. Even if this lack of candor does not on average fool the marginal investor, it may fool some bank managers and lead a few of them to believe that they can sometimes con a few uninsured creditors and even bank regulators, if only for a while. To the extent that intrinsic-value accounting leads to taxpayer, regulator, and managerial confusion, market-value reporting represents a promising way to lessen unintended deposit-insurance subsidies to risk-taking and to increase the safety and soundness of the banking system.

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Mr. McKinney.

Mr. McKinney. Thank you, Mr. Chairman. We have been wandering around my pet subject, both for the regulators and everyone else in it, which is asset quality. It seems to me that what we have been discussing a crises of asset management from Penn Square through Continental Illinois, to San Marino and all of the rest of them. I have two questions for any of you.

To start, could the banks and S&L's stand the shock of actually going to market value accounting at a time certain? And Second, how could regulatory agencies get a grip on the assets situation so that in fact we are there before the fact rather than after the fact?

We are there after the collapse instead of before the collapse. Would anyone like to start on that? Mr. Sexton?

Mr. Sexton. Sometimes it appears that we arrive on the scene a little bit late. We have quite a few success stories in our files where we got there on time, and we are able to keep that bank off the casualty list. But as far as getting to the assets that require regulatory diagnosis in my estimation there are too few regulators these days.

The regulatory agencies have cut back or have not hired near what they need to hire. In addition to market discipline you need regulators to identify the items that are not transparent on published calls, for instance, and the item that is not transparent is asset quality, just as you mentioned. So, if you don't get the regulators in there, if you don't have a program featuring both market discipline and enough regulators to identify the problems, then you don't have a complete program.

Mr. McKinney. Mr. Sexton, it is only fair to say I have been a little hard on your State in these hearings, but far harder on California because I cannot understand why the full faith and credit of the American taxpayers should be behind institutions, particularly in California, that do things and have things which we don't consider to be assets. I consider them to be risk gambles, but the State legislature in California allows them to do that. What about this subject of one institution, the California Legislature, the Texas Legislature, setting the rules and then the U.S. Government and all of its taxpayers having to pay for the results?

Mr. SEXTON. Well, as long as the States are confining themselves to innovativeness that is safe and sound, I surely have no problem with that. The Texas banking system has only traditional banking powers. Nothing else is permitted. I think the S&L's go considerably beyond that.

Chairman ST GERMAIN. I was going to point out, Mr. Sexton——

Mr. MCKINNEY. I am aware of that.

Chairman ST GERMAIN. S&L's have a different supervisory agency.

Mr. MCKINNEY. If any at all.

Mr. SEXTON. But that is one. To engage in these activities, and to gather the funds to engage in these activities in the city of Houston, on a given day, you will find savings and loans—thrifts paying 50 to 125 basis points more than the banks are paying, which gives rise to my statement that we impose some limits somewhere to keep that sort of mischief from occurring, because there it has been found that all insured institutions are issuing what is tantamount to Federal securities when they issue a deposit and they found that the more they pay, the more of those they can issue. The more they issue, the more things that they can get into. So I don't know how to address that without some way restricting the flow of funds into these institutions.

[The following supplementary letter was received from Mr. Sexton for inclusion in the record at this point:]

Department of Banking
2601 North Lamar
Austin, Texas 78705
(512) 475-4451

JAMES L. SEXTON
COMMISSIONER

RECEIVED
SEP 24 1985
Subcommittee on Financial Institutions

SEP 24 1985
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Banking, Finance & [illegible] Committee

September 20, 1985

The Honorable Fernand J. St Germain
Chairman - Committee on Banking,
  Finance, and Urban Affairs
U. S. House of Representatives
Rayburn HOB, Room 2129
Washington, D. C. 20515

Dear Mr. St Germain:

In my September 18 testimony concerning deposit insurance reform, I mentioned that, in Houston, thrift institutions pay interest on deposits at a level "50 to 125 basis points above that paid by banks, depending on the deposit category."

Since that statement drew a fairly strong reaction from you and certain members of your Subcommittee, I would appreciate the opportunity to enter into the record the following figures taken from the September 18 Houston Post, which compiles rates quoted on Wednesday of each week by ten principal Houston banks and ten principal Houston savings and loan associations.

	In Basis Points			
Differences between:	MMA	Spr. NOW	6 mo.	1 yr.
Avg. bk / Avg. S&L	55.[illegible]	99.4	63.8	77.7
Hi bk / Hi S&L	67.0	149.0	89.0	98.0
Hi bk / Lo S&L	(13.0)	28.0	10.0	(10.0)
Lo bk / Hi S&L	103.0	238.0	114.0	148.0
Lo bk / Lo S&L	23.0	45.0	35.0	40.0
Avg. bk / Hi S&L	93.1	179.4	104.0	129.0

Note: Figures in brackets indicate the bank is paying the higher rate; in all other instances the bank is lower.

The table from which the foregoing were derived is enclosed.

The aberrational highs in the table, and my having seen the same pronounced rate spikes elsewhere, involving banks but more frequently thrifts, occasioned my recommendation that there be imposed a rate ceiling based on rate indices among financial institutions in the various Federal Reserve Districts, plus a modicum (perhaps 50 basis points) of upward margin to allow for the pursuit of legitimate marketing programs. I continue to be convinced that in the upper reaches of the interest rate matrix one finds not the "market" working, but mainly a concentration of those who are playing with the public's money and perhaps have little to lose in so doing.

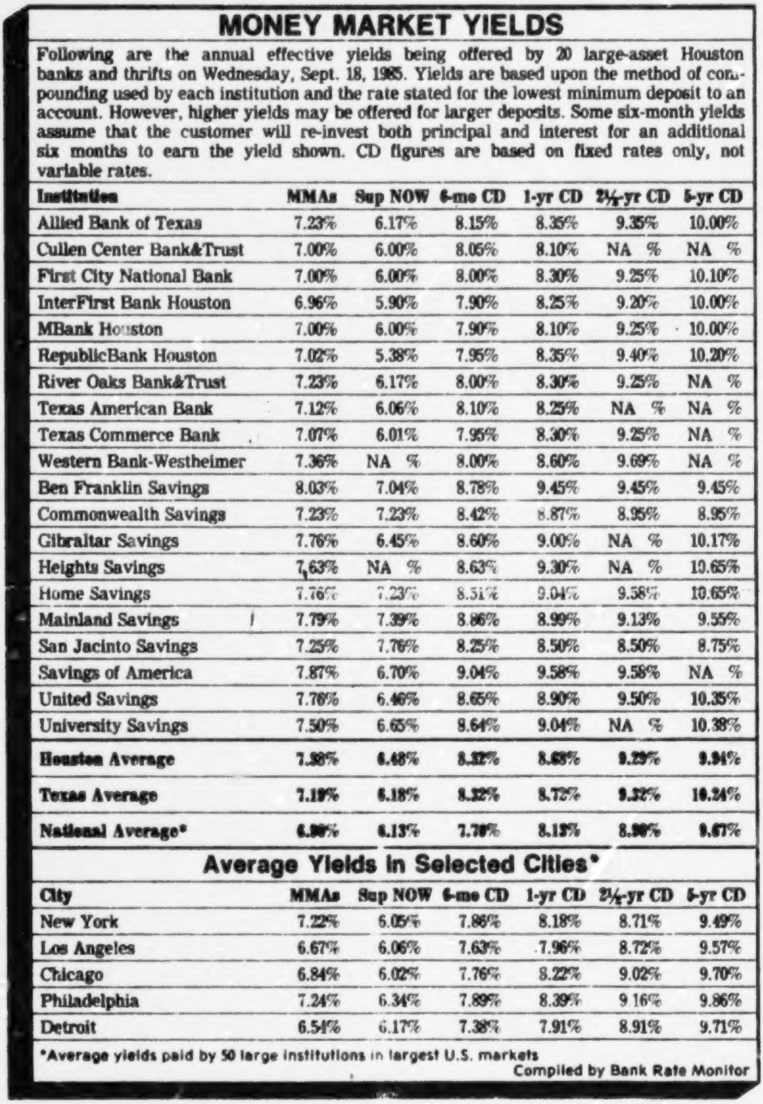
Once again, thank you for your interest in my point of view. I will look forward to receiving the "additional questions" on which the Subcommittee would like opinions expressed.

Sincerely,

James L. Sexton

James L. Sexton
Commissioner

JLS:kbc
Enclosure



MONEY MARKET YIELDS

Following are the annual effective yields being offered by 20 large-asset Houston banks and thrifts on Wednesday, Sept. 18, 1985. Yields are based upon the method of compounding used by each institution and the rate stated for the lowest minimum deposit to an account. However, higher yields may be offered for larger deposits. Some six-month yields assume that the customer will re-invest both principal and interest for an additional six months to earn the yield shown. CD figures are based on fixed rates only, not variable rates.

Institution	MMAs	Sup NOW	6-mo CD	1-yr CD	2½-yr CD	5-yr CD
Allied Bank of Texas	7.23%	6.17%	8.15%	8.35%	9.35%	10.00%
Cullen Center Bank&Trust	7.00%	6.00%	8.05%	8.10%	NA %	NA %
First City National Bank	7.00%	6.00%	8.00%	8.30%	9.25%	10.10%
InterFirst Bank Houston	6.96%	5.90%	7.90%	8.25%	9.20%	10.00%
MBank Houston	7.00%	6.00%	7.90%	8.10%	9.25%	10.00%
RepublicBank Houston	7.02%	5.38%	7.95%	8.35%	9.40%	10.20%
River Oaks Bank&Trust	7.23%	6.17%	8.00%	8.30%	9.25%	NA %
Texas American Bank	7.12%	6.06%	8.10%	8.25%	NA %	NA %
Texas Commerce Bank	7.07%	6.01%	7.95%	8.30%	9.25%	NA %
Western Bank-Westheimer	7.36%	NA %	8.00%	8.60%	9.69%	NA %
Ben Franklin Savings	8.03%	7.04%	8.78%	9.45%	9.45%	9.45%
Commonwealth Savings	7.23%	7.23%	8.42%	8.87%	8.95%	8.95%
Gibraltar Savings	7.76%	6.45%	8.60%	9.00%	NA %	10.17%
Heights Savings	7.63%	NA %	8.63%	9.30%	NA %	10.65%
Home Savings	7.76%	7.23%	8.51%	9.04%	9.58%	10.65%
Mainland Savings	7.79%	7.39%	8.86%	8.99%	9.13%	9.55%
San Jacinto Savings	7.25%	7.76%	8.25%	8.50%	8.50%	8.75%
Savings of America	7.87%	6.70%	9.04%	9.58%	9.58%	NA %
United Savings	7.76%	6.46%	8.65%	8.90%	9.50%	10.35%
University Savings	7.50%	6.65%	8.64%	9.04%	NA %	10.38%
Houston Average	**7.38%**	**6.48%**	**8.32%**	**8.68%**	**9.29%**	**9.94%**
Texas Average	**7.19%**	**6.18%**	**8.32%**	**8.72%**	**9.32%**	**10.24%**
National Average*	**6.90%**	**6.13%**	**7.70%**	**8.13%**	**8.90%**	**9.67%**

Average Yields in Selected Cities*

City	MMAs	Sup NOW	6-mo CD	1-yr CD	2½-yr CD	5-yr CD
New York	7.22%	6.05%	7.86%	8.18%	8.71%	9.49%
Los Angeles	6.67%	6.06%	7.63%	7.96%	8.72%	9.57%
Chicago	6.84%	6.02%	7.76%	8.22%	9.02%	9.70%
Philadelphia	7.24%	6.34%	7.89%	8.39%	9.16%	9.86%
Detroit	6.54%	6.17%	7.38%	7.91%	8.91%	9.71%

*Average yields paid by 50 large institutions in largest U.S. markets

Compiled by Bank Rate Monitor

Chairman **St Germain**. Excuse me.

One way would be to talk to the Legislature of Texas. Why don't you take a look at the powers you are giving the S&L's?

Mr. **Sexton**. Well, there is not much of a constituency for that. I guess that my posture has been exactly as you suggest, since my constituency is the banking industry, which has been partly covetous of and partly scared of the powers that the savings and loans have in Texas. So, I would agree with you, but I don't think there is a lot of constituency in Texas for that.

Mr. **McKinney**. Anyone else?

Mr. Silverberg, would you like to comment on this asset alarm bill, so to speak?

Mr. **Silverberg**. Even if you can't find the problems before the fact, you can come in afterward and locate and correct them. You can place an appropriate limit on leverage—and I think Mr. Carron was talking earlier about S&L's expanding and taking on risks without any capital. One approach would be to not allow such institutions to grow if indeed you can't close them. By making capital demands or putting appropriate pressure on them, I think you force institutions to be more cautious in its lending policies.

That doesn't solve the problem if we are talking about stupidity or incompetence, that is hard to deal with, but we can at least come in after the fact and try to impose some sort of after-the-fact discipline.

Mr. **McKinney**. My time has expired. I would like to add to our lexicon after incompentency and stupidity the word "fraud." I think, unfortunately, we have seen that in many of the S&L collapses, particularly in the State of California.

Mr. Chairman, I would like to ask unanimous consent to send some other questions to these gentlemen, because I would like to find out about bearer bonds and a few other things.

Chairman **St Germain**. I would like to say to Mr. McKinney that these gentlemen—I mean seriously, they are very interesting and they are very helpful, so we are going to have a few rounds of questions. I hope that you will be around, too. Certainly if you are not able to, if you still have questions, we will have unanimous consent to propound additional questions in writing. I am sure they will be happy to cooperate.

Mr. **McKinney**. Thank you.

Thank you, gentlemen.

Chairman **St Germain**. Mr. Roth.

Mr. **Roth**. Thank you, Mr. Chairman.

The question I have, and I suppose the question that many of the people in our congressional districts—not only mine, but of the others also—is how secure are we? We have $100,000 FDIC insurance, put our money in the bank. Suppose a couple of banks, whether it is Continental or whatever the bank might be, become insolvent. How secure are our deposits today? I would like to ask Mr. Kane, because he has touched on that somewhat?

Mr. **Kane**. Well, of course, how secure the deposits are depends first on what kind of institution we have placed them in. The conviction that some banks are too large to liquidate and, therefore, too large not to have their depositors fully insured de facto means that these large institutions offer more secure deposits. Their depositors are offered better guarantees than depositors in smaller institutions.

What I am insecure about is the possibility of bureaucratic breakdown. The congressional guarantee passed in 1982 is merely a resolution and, strictly speaking, a nonbinding resolution. It claims to put the full faith and credit of the United States behind the deposit-insurance funds, but it sets up no financial mechanism to make good on that guarantee if an emergency were to arise.

Let us suppose FSLIC resources were suddenly to become exhausted. Authorities would be in a bureaucratic panic. They would have to decide overnight what to do. No agency is strictly empowered to make these decisions. Congress might have to go into emergency session. If it did, it would find many problems to debate. These problems would require some time to resolve. During that time, customers probably could not get all of their funds. I would envision a partial banking holiday, a holiday for FSLIC-insured institutions.

This problem could be avoided by deciding now what Congress would prefer to do to back up the FSLIC by the full faith credit of the Treasury. Many people are attracted to the notion of merging the FDIC and FSLIC. Others want to develop a new vehicle that can inject—or more accurately, seem to inject—additional capital into FSLIC.

My concern is that in recapitalizing the FSLIC Congress should straighten out the subsidy problem while they have the system up on the rack. Otherwise they are merely going to buy time without using this time wisely. The result will be to encourage new and bigger problems down the line.

The FDIC does not have much in the way of excess reserves. If Congress loads the FSLIC's insolvency onto the FDIC, it won't be long until the FDIC begins itself to buckle under the load. If nothing else is changed, the problems that we now worry about hitting the FSLIC will soon threaten the combined fund.

Mr. Roth. Well, I agree with you. The thing that I think brings consternation to all of us, panic, something like that, would ensue if you had a couple of banks in trouble, and if you had FDIC saying "I don't know if we could stand behind the money." You would have riots I believe in this country. If I interpret what you say correctly, you are saying that what concerns you more than anything is that there is no structure, no procedure if that would happen.

Mr. Kane. No procedure exists to deal with this very difficult and all-too-possible case of the FSLIC's being tested and its resources used up. I can think of several different ways in which an FSLIC insolvency could be handled. First, the Federal Reserve could provide funds to tide the situation over while Congress made a decision, but to do this Fed officials would have to move beyond the accepted parameters of the discount-window policies that they have followed in the past.

Mr. Roth. Besides what you just mentioned—the Federal Reserve—what should Congress be addressing itself to? Do you have any other steps or recommendations?

Mr. Kane. The point is, Congress should say——

Mr. Roth. You are making the Federal Reserve almost like a dictatorship for a while as far as our financial institutions are concerned?

Mr. Kane. I am saying the Federal Reserve has the responsibility to serve as lender of last resort, which makes it effectively the financial stabilizer of last resort. It is expected to try to help troubled institutions liquify their portfolios. A failing FSLIC could be construed as an institution deserving of help under a broad reading of the Fed's mandate. Under a narrow reading of that mandate, an insolvent FSLIC could not borrow from the Fed. The issue of borrower solvency is where Fed officials would have to blend a bit. But they could proceed. But it is not satisfactory that Congress and market participants can't know in advance the contingent policies Fed officials would follow.

A chance exists that at the time the trouble developed, Fed officials might worry overmuch about breaking longstanding traditions. This would add to uncertainty at that time and could force Congress to act rashly.

Decisions made in a crisis atmosphere are apt to create unforeseen long-run problems. If Congress starts considering an emergency plan now, when it is not under crisis pressure, reasoned decisions can be made about how Congress wants to back up the deposit insurance funds and to what extent.

Mr. Roth. Do you think it would be prudent for Congress as we are working on this legislation, to consider a delineation of those steps that should be taken?

Mr. Kane. Absolutely.

Mr. Roth. Thank you very much, Mr. Chairman.

Chairman St Germain. Mr. McCollum.

Mr. McCollum. Thank you, Mr. Chairman.

Several of the panel today have indicated that to support subordinate debt would be something that could be used, in addition to equity capital, to provide the necessary reserves and capital for purposes that different ones have advocated but in Mr. Carron's testimony I found an interesting comment that puzzles me. You indicated that you felt that subordinate debt holders were sophisticated. If they purchase the subordinate debt they would impose restraint on the institution. I am curious as to how in reality, in the real world, they would actually impose restraint? I am a little puzzled if they are not members of the board of directors and use institutions that are already in the condition, particularly those like the S&L's that are troubled, are going to particularly listen to subordinate debt holders.

Mr. Carron. The discipline is imposed at the time that the debt is sold. This is not perpetual debt. It matures and has to be refunded, and so the idea would be that this institution would come to the capital markets every year or every other year and have to meet the test of the markets. Now, it is always possible that you could have a very well run institution that would make a decision the day after a refunding to go wildly into some new area and hope for the best between that and the time 2 years hence when they would have to go back for more funding. In practice, that is not what happens in capital markets. You can look at the experience of the firm and it takes time for investment policies to be developed and for changes to be observable in the direction of these institutions.

Mr. McCollum. Your point is that at the time that the institution has to go seeking the buyer to buy the subordinate debt, that at that point in time the restraint will be imposed simply by the sensity of accounting to the would be purchaser?

Mr. Carron. Yes sir.

Mr. McCollum. I think that is a good point. I was curious how you felt the marketplace would work in that regard.

Mr. Silverberg, in respect to one of the points that you made that you did support the merger of FDIC and FSLIC, we have heard quite a few different comments certainly in the past in opposition to that. One of the arguments is that if you merge two funds you have the effect of basically wiping out the distinction between thrifts and banks. How do you respond to that?

Mr. Silverberg. Well, I believe, sir, that over time that wiping out of the distinction is probably a logical development. That does not preclude some institutions specializing in housing and specializing in the retail side. From a deposit insurance standpoint, if the insurance has the same characteristics and it is good whether it is an S&L or a bank, we are talking about deposit instruments that are interchangeable.

I think we are talking about accounting standards and the kinds of supervisory standards that ought to be applied across the board.

Mr. McCollum. You don't basically have any problem with the trend toward doing that and the distinction doesn't need to be made as great as it has been in your judgment?

Mr. Silverberg. That doesn't mean that every institution would focus on the same set of customers or necessarily concentrate on the same business.

Mr. McCollum. How do you respond to the critics? I think Professor Kane was somewhat one a while ago. He said merger of the two insurance funds doesn't really give much deeper pocket FDIC, doesn't have much resources. We are only kidding ourselves if we put that down, as one of the solutions to this problem.

Mr. Silverberg. Well, that is not a real concern, I think. I would view the FDIC situation today as certainly strong enough to handle any commercial bank problems that we could conceivably foresee.

Clearly a merger of the funds would expose the FDIC, would spread the FDIC's net worth much thinner and would involve picking up additional problems. We have gone through some calculations. We think under reasonable circumstances that the situation would be manageable, but I would concede that it would certainly reduce the kind of margin of safety that we have.

Mr. McCollum. Wouldn't the net effect also be to increase the burden and the cost of the S&L problems and commercial banks or shifting the cost over there?

Mr. Silverberg. Well, under the proposals that we looked at we have tried to deal with some kind of a phase-in arrangement where at least for some period of time there would be some separate accounting so that for several years the net assessment on banks would not be raised or would not be affected by performance on the S&L side. Ultimately, that could have an impact though.

Mr. McCollum. Mr. Carron, you indicated that you didn't agree, I don't believe, with Dr. Silverberg's analysis of the savings to the taxpayers involved in this or at least you didn't see any economic impact.

I think Mr. Silverberg indicated he thought the merger between FDIC and FSLIC could have a savings. I assume that is based on the assumption we might have to come in and use tax dollars to bail out the FSLIC.

What is your response to that situation, since you indicated you saw no economic advantage to the merger?

Mr. Carron. One of the points that I made in my opening statement was that the economic costs have already been incurred in the losses which exist, but are not yet shown on the balance sheets of these institutions, and once you make that statement, all you are doing is saying how shall we allocate the costs of those problems? Should we allocate them to the thrift problem, shall we spread them across banks and thrifts, and to the extent that that may be insufficient, should we go to the Treasury and pay for it that way?

The economic costs have already been incurred and it is a side issue how you want to allocate those costs.

Mr. McCollum. There would be potentially some savings to the taxpayer by the merger in the sense that there is an FDIC that is stronger theoretically. We might have to come sooner with congressional direct infusion of tax dollars if we don't do that. Isn't that a fact?

Mr. Carron. That would be true if you were to merge the funds, but if you maintain separate accounting, as has been suggested here, then you don't get that advantage. So either the banks are going to pick up the tab or the taxpayers are going to pick up the tab.

Mr. McCollum. Thank you both.

Chairman St Germain. Mr. Bereuter.

Mr. Bereuter. Thank you, Mr. Chairman.

Mr. Silverberg, regarding the alternatives of substantially raising the capital requirements of FDIC insured banks, has your agency studied or determined how many banks would have difficulty in being able to meet substantially increased capital requirements at this moment, how many institutions, and what would happen to those institutions that could not?

Mr. Silverberg. We have run numbers on how many banks would need how much capital if, for example, the 9-percent number were imposed immediately. Now, you have to appreciate that we are talking about a proposal that would phase the higher capital requirements in over about a 6-year period.

Generally, smaller banks don't have much problem. They start out with relatively higher capital ratios. Our view is that among the larger institutions there are a few that are in fairly strong credit positions. Probably the greatest burden would be placed on a number of the largest banks whose financial strength is not all that great, who might have difficulty going to subordinate debt markets on relatively favorable terms. I think that some of those institutions would have to pay premium rates. They might have to direct their policies so that their projected growth is cut back. They might have to do some other things.

But the shortfall, we believe, would be principally among larger institutions that don't have the sort of blue ribbon credit quality. For example, we would think that for Morgan Guaranty, this proposal would pose no problem because we would assume that they could easily go to the capital markets and raise funds cheaply. That would not be the case for all larger institutions.

Mr. **Bereuter**. Have you noticed that the majority of the bank failures in the country that have taken place this year are in the Western Grain Belt?

Mr. **Silverberg**. Yes sir.

Mr. **Bereuter**. And would you not agree or are you able to comment on the difficulty that those banks would have in meeting increased capital supplies, let alone maintaining capital ratio?

Mr. **Silverberg**. Well, actually, the rather strange thing is that many of these surviving institutions in the agricultural States have relatively high capital ratios, and I can appreciate that this proposal is not going to solve all of the immediate problems and effectively handle all problems. We do have serious weaknesses in selected sectors of the economy, and those weaknesses are with us, and they probably will continue to be with us.

Mr. **Bereuter**. That is indeed true. I would urge you to take a look at the great diversity in capital ratios in agricultural banks in the Great Plains. Some indeed have very high ratios, but others are going to have a great difficulty, and you are going to be accentuating the difficulties we have in that part of the country with the deflationary impact upon land values that monetary policies and other things have given us. So I hope you are very cautious about making recommendations in that area until you look at the number of banks that will have great difficulty and that you will not look at averages.

Mr. **Silverberg**. Sure. I would like to point out that if we look at the set of alternative proposals, you would also have to use the same test in looking at what the impact would be on agricultural banks.

For example, Professor Kane suggested, we ought to subtantially reduce the deposit insurance coverage. The burden on many of the agricultural banks that we are talking about would be much greater. If the proposal is that we do try to implement a market value accounting system as soon as possible, I don't know what the impact of that proposal would be on the solvency of many agricultural banks. I think the economic difficulties we are talking about are there and these are going to be problems created by the implementation of any of the alternatives that are on the table today. I think that it becomes necessary to handle and implement any of these policies with the right degree of flexibility in recognizing those problems.

Mr. **Bereuter**. I believe there is merit in what you are saying. It is a rational statement, but I encourage you to look very carefully at the numbers of specific banks with those difficulties and their high concentration in some geographic areas in the country.

Mr. **Silverberg**. Sure.

Mr. **Bereuter**. I would like to ask Dr. Kane if he would respond to a question.

Mr. **Kane**. Sure.

Mr. **Bereuter**. How do you react to Mr. Carron's suggestion that risk related premiums may induce the marginal institution to assume even larger risks?

Mr. **Kane**. Well, we must recognize that deposit insurance is really an unconditioned financial guarantee rather than an insurance contract proper. One cannot sell such a liability rationally unless one sets up an appropriate monitoring and response system for controlling one's exposure to loss. One dare not charge customers only for the risks that they are now carrying. One must worry about additional risks customers could undertake. One wants to remove incentives for customers to become more risky once they have signed up.

Risk-related premiums require effective monitoring as part of the package. That is another way that market-value accounting can be useful. It provides the best flow of relevant information to the insurer. It is something that a private insurer would prefer.

Mr. **Bereuter**. Thank you.

Chairman **St Germain**. Professor Kane, I am fascinated by the suggestion of private insurance. As I recall, you said earlier to Mr. Wylie that you would lower the coverage of the insuring fund, the federally insured coverage, and then there would be private insurance over and beyond that.

Let's say a private insurer insures the excess funds, and that a bank proceeds to make loans that are risky. The bank is perceived by the insurance company—all of a sudden they find out this particular bank is paying a little higher interest rate and bringing in broker deposits to a heavy degree—and obviously this institution is now having problems. Would that insurance company then be able to say to the bank, OK, we are canceling our insurance?

What guarantee would there be to the depositor that the excess insurance provided by the private insurance company would be there?

For instance, right now, we are looking at some private mortgage insurance companies that are in dire straits as a result of the situation in Maryland; correct?

Mr. **Kane**. Yes sir.

Chairman **St Germain**. Who knows where the money is going to come from. They may not be able to cover their losses. So how does the depositor get any umbrage or solace or feel safe and comfortable?

Mr. **Kane**. When you hold an insured asset, you have to ask who is insuring the item and how strong they are. You need to monitor your insurer's financial condition. You need to be concerned about it.

Chairman **St Germain**. Also—in fact, I will include this in my question—this is essential. What tools, let us say, does the private insurance company have to discipline the financial institution?

Mr. **Kane**. I want to address both of those questions. Noting the imperfect credibility of private insurers is to recognize that generally speaking we don't demand perfect insurance for things. Policies such as automobile insurance often have deductible as does health insurance. Other policies have co-insurance where the insured shares a percentage of the damages. Major medical policies sometimes have lifetime cumulative limitations, so that if we experienced a catastrophic illness, we wouldn't be fully covered. It doesn't pay to cover all risks. Instead, we decide that some unfavorable events are too expensive to insure.

Chairman **St Germain**. I thought, Professor Kane, what you were saying was: Let's lower the FDIC insurance to $50,000 and the other private insurance company can provide from $51,000 to $100,000. As an example. I mean, did I miss——

Mr. **Kane**. No, no, that is exactly right. What I am trying to get at is that by reducing the maximum coverage we would indeed be lessening the perfection of deposit insurance. We would be encouraging depositors to respond to market signals about insurers and about institutions. If one wants to be perfectly covered, one can put one's money in U.S. Treasury debt or in mutual funds that specialize in U.S. Treasury debt.

Today, deposit institutions can sell the equivalent of government debt, while taking great risks and imposing these risks on Federal taxpayers. If these additional coverage options were available, depositors who become worried about insurers or institutions would be encouraged to move their funds. The possibility that they could move them would create incentives for insured institutions to take less risk in the first place.

Deposit insurers must have a risk-management system. The deposit-insurance firm in North Carolina that I mentioned reserves the right to intervene totally in the affairs of any of its member institutions that it deems to be taking undue risk. An institution accepts this covenant to be able to qualify for that insurance. No firm has to buy insurance from this company. If it does, it has to cede that company those rights. Ideally, the monitoring and response systems that constitute the insurer's risk-management controls should be negotiated between the insurer and the deposit institution.

One of my most severe criticisms of the Federal deposit insurers is their failure to develop an adequate risk-management system from the point of view of controlling taxpayer liability in the face of secular increases in the riskiness of the financial environment in which insured institutions operate.

Chairman **St Germain**. But I think the North Carolina Private Insurance Co. has developed those standards to a better degree.

Mr. **Kane**. It uses a contract that gives it rights that protect the members of the insurance pool from aggressive risktaking by other members. Again, Ohio did not have that sort of system.

Chairman **St Germain**. Mr. Silverberg, have there been any institutions in North Carolina that have applied to the FDIC for insurance coverage that were not covered by FDIC prior to the Ohio incident?

Mr. **Silverberg**. Yes, quite a few. It is my impression there has been an effort to encourage the institutions Mr. Kane is talking about to obtain FDIC insurance.

Chairman **St Germain**. As a matter of fact, we know full well, Professor Kane—and this just indicates that a private insurance company is being questioned because of what happened in Maryland and Ohio.

I am not saying that is justifiable or not, but the fact of the matter is that people have faith and confidence in the FDIC and FSLIC. At this point, there would have to be a tremendous selling job to be done to convince them that a private insurance company is the way to go.

Now, let's not kid each other. Maybe an institution has private insurance over $50,000, let us hypothesize, but the fact of the matter is that a lot of people are going to put $50,000 into the Carron Bank, and then they are going to be next door to the Kane Bank and put $50 in rather than putting $100 in the Carron Bank, feeling that $50 is covered by the FDIC and $50 by the Sexton Insurance Co.

I don't mean to be derogatory, Mr. Sexton.

Mr. **Kane**. My point is the biggest selling job that can be done would be done by prices if the true costs of the current system were revealed. If the government were to charge institutions, depositors, or taxpayers what it really costs to provide deposit insurance, institutional decisions about how much risk to carry would fall into line with that cost. Today, because authorities don't charge enough for the guarantees they provide, the true cost is not passed through to depositors.

Depositors fail to receive the right signals. Now, the North Carolina insurance fund responded to the Ohio crisis by encouraging its members to switch their insurance to the Federal Government. Moreover, although I have not checked this closely, a much larger percentage of their members seems to have readily qualified for membership than proved true for the State-sponsored systems. The firm was saying that the riskiness of the environment had increased so much that it would be wise for its clients to purchase their deposit insurance from the Federal Government, with its deep pockets and its subsidized guarantees. Uncertainty created by the Ohio banking holiday had made deposit-insurance guarantees more valuable than ever before. This was reasonable advice.

This company did give people good signals, which we may contrast with the signals emitted by the State-sponsored fund in Maryland. Maryland politicians tried to bluff their way through it all. Unrealistic blustering is a temptation that is hard for a State-sponsored corporation to resist.

Chairman **St Germain**. No. 1, we are looking for solutions to our dilemmas and right now it doesn't seem as though a private insurance company in this climate is the solution; right?

Mr. **Kane**. I want supplemental private insurance, but the point to be made is that no medicine strong enough to cure what's wrong with the deposit-insurance system is going to taste good. Effective medicine is going to be difficult to get down. Every single recommendation I would make is going to impose increased costs on deposit institutions or their customers, at least initially.

Various people are going to have to bear pain that authorities have been hiding by postponing treatment. You have pointed out the problems with private insurance. The other gentleman pointed out the problems with increased capital requirements. Every worthwhile reform is going to hurt somebody somehow. Depositors are going to have to settle for less perfect guarantees or more costly guarantees. That is the choice.

Chairman **St Germain**. We are going to recess for 10 minutes. There is a vote in progress.

Mr. **Wylie**. Mr. Chairman, before we do that, I wonder, Professor Kane's statement was very short here this morning. He gave a very thorough explanation of his views before the Mid American Institute recently, and I just happen to have a copy of his paper here.

In glancing through it, I think it might be a good addition to the record of the hearing this morning. I would ask unanimous consent that it be included.

Chairman **St Germain**. Is there objection?

The Chair hears none.

Mr. **Wylie**. I am not going to ask to put his book in, Mr. Chairman.

Chairman **St Germain**. He might object to that.

Mr. **Kane**. I didn't hear that.

Chairman **St Germain**. I said that I hope you are not going to ask unanimous consent to put the new book in.

Mr. **Kane**. My publisher, MIT Press, would surely object.

Chairman **St Germain**. I said maybe Professor Kane might object.

Mr. **Kane**. The MIT press might object.

Chairman **St Germain**. We will be in recess for 10 minutes.

[Recess.]

[The paper of Professor Kane referred to by Congressman Wylie was submitted for the record earlier and follows Professor Kane's statement.]

Chairman **St Germain**. The subcommittee will come to order.

Mr. Silverberg, I was interested in your reply about the merging of the funds and the fact that you felt that the thrifts are getting closer and closer to commercial banks.

Let me ask you this: How many commercial banks would you say specialize and concentrate on very heavy home mortgage financing?

Mr. **Silverberg**. In terms of high portfolio portions, probably a fairly small percentage, but I believe that most commercial banks, particularly those outside of money centers, have very significant home mortgage operations and particularly with the growth of variable rate and roll over mortgages are active participants in those markets.

We went through some analysis of how many commercial banks have as much as 30, 40, 50 percent of their asset portfolios in mortgages, and the numbers are relatively small.

Chairman **St Germain**. That was my recollection from testimony in previous hearings over the years. I just wondered if that still prevailed. Mr. Silverberg, as far as the FDIC is concerned, what is the amount of the fund? What is the size of the fund, the insuring fund at this point in time?

Mr. **Silverberg**. I believe the current number is very close to $19 billion. That is our net worth.

Chairman **St Germain**. That is the fund now. Of course, you have some reserves; don't you? In other words, Continental has a certain exposure for you, and will have for periods of time, as well as many other banks around the country where you have assisted with mergers, et cetera.

What terminology do you use for that?

Mr. **Silverberg**. If I just put aside Continental for the moment, the $19 billion represents our net worth. Now as you know, we have outstanding assistance agreements in connection with some of the savings bank transactions. We have reserved the present value estimates of that assistance, so that it is already reflected on our balance sheet and the $19 billion is a net worth number.

Chairman **St Germain**. In other words, you take the savings banks, if you didn't have those funds committed or possibly set aside, you would be above $18 billion. Is that what you are telling me?

Mr. **Silverberg**. Yes, that is right. We have not reserved yet, as you know, for Continental, and I think there will be some effort by the end of the year to make an estimate, though, I believe it will be difficult for, as you know, in that transaction Continental has the option of putting certain loans back to the FDIC.

They have not fully utilized that put, so that any estimated by the end of the year will be a difficult one.

Chairman **St Germain**. What was the amount of loans that the FDIC took from Continental, that were classified loans and nonperforming loans, et cetera?

Mr. **Silverberg**. The FDIC basically committed to purchase $4½ billion in book loans for $3½ billion. Now there have been some collections on some of those loans that have—

Chairman **St Germain**. That was a matter of controversy with the GAO, wans't it, now that I am recalling it.

Mr. **Silverberg**. Yes.

Chairman **St Germain**. Did you say $4½ billion?

Mr. **Silverberg**. Four and a half billion dollars was the book figure on Continental's books as of May 1984.

Chairman **St Germain**. On the loans the FDIC took from Continental?

Mr. **Silverberg**. Three and a half billion dollars was basically the amount of money paid to Continental for those or paid if and when the full amount of those loans are put. Continental has not fully used that put. In other words, there was an initial purchase, and Continental had the option of selling additional loans which they have not fully utilized as yet.

Chairman **St Germain**. To the FDIC?

Mr. **Silverberg**. Basically to the FDIC; yes.

Chairman **St Germain**. So as of now, the FDIC—you have got—I am not getting an answer to my question. As of now?

Mr. **Silverberg**. Yes.

Chairman **St Germain**. OK. In order to make Continental solvent, so to speak, the FDIC went in and purchased nonperforming loans and classified loans, loans that were of questionable value. The amount of those loans, or the amount of money that the FDIC paid for those loans, after it was over, was how much?

Mr. **Silverberg**. Three and a half billion dollars.

Chairman **St Germain**. Three and one-half billion dollars, and there is a possibility they might take over another $1 billion.

Mr. **Silverberg**. No, I am sorry. Let me go back.

Three and half billion dollars was the maximum amount FDIC would pay.

Chairman **St Germain**. So you have $3½ billion that you would deduct from the $19 billion. This is hypothesizing. I am not saying that is exactly what is going to happen, but there is potential.

Mr. **Silverberg**. Sure.

Chairman **St Germain**. Good. I know you people are very touchy when we ask questions about Continental, but, jeepers, it is all out in the open, Mr. Silverberg.

Mr. **Silverberg**. We have already collected on some loans—the $3½ billion number is not really an outside number. It is a number that is outside the range of possibility.

Chairman **St Germain**. Well, let's put it this way. By the same token, who was it that testified from the FDIC the other day? Mr. Poling was right here from that venerable agency.

Mr. **Silverberg**. Right.

Chairman **St Germain**. He said that, Mr. Silverberg, "We are only 51 years old, Mr. Chairman."

It is the statute that makes it venerable. Veneration doesn't come with age, Mr. Silverberg.

Mr. **Silverberg**. I see.

Chairman **St Germain**. All right. He stated that there is no way of telling how many banks will fail next year. However, he anticipates a substantial number of failures next year so that would affect the fund as well.

Professor Kane, let's talk about Texas now. Of course, we realize that Mr. Sexton is not a full Texan because he disagrees with what S&L powers are, and the items that were considered by the State legislature there regarding what S&L's can invest in. I don't want him to take offense.

Here in Texas—you heard Mr. Sexton say S&L's are paying pretty high rates of interest, but we find, I think, that a lot of funds are coming in there that are brokered funds. The Texas S&L's are investing in some rather unusual, speculative types of items.

Have you made any decisions about brokered funds, Professor Kane? I would like to extrapolate that from your voluminous writings.

Mr. **Kane**. The problem with brokered funds is that failing and other aggressively managed institutions are able to raise fully insured money from all over the country in large amounts very quickly. They can put these funds to whatever use they want unless the regulator is closely monitoring their activity. As we have seen, regulators are a bit slow to size up a changing situation and control an institution's risktaking.

Chairman **St Germain**. The courts have taken issue with the regulators stopping them as well.

Mr. **Kane**. Yes, I understand the history of brokered deposits. I testified about them in the Commerce Committee several years ago when the issue first surfaced in the House. Deposit insurers have been trying to find some way to control the exposure of their deposit-insurance reserves to the activity of brokerage firms willing to place funds in institutions that are in the midst of last-ditch gambles. It is important that they solve this problem.

I understand why the courts overruled the agencies' initial proposals, but Congress should be concerned with helping them to get a handle on this kind of risktaking. A couple of different approaches could be adopted. It is important to recognize that once a firm is likely to seek additional resources energetically once it sees itself as likely to be closed the next time the examiners visit it. Its managers' goal is to raise enough funds to place a bet that has a chance of getting the firm back to solvency before the examiners arrive to close it down.

Chairman **St Germain**. I am going to ask the same questions of the other members if they want to address it. The other side of this is that many brokerage houses tell us that they have sophisticated means of determining the viability of financial institutions, and that they do not place brokered funds in any institutions that are in jeopardy. They just place those funds in institutions where they feel there is no danger.

Do you think that brokerage houses have the capacity to analyze S&L's and commercials, and can be more effective than the FDIC?

Mr. **Kane**. First, they could be required to warrant that judgment to the FDIC and FSLIC and bond their warranty in some way. If they did accept this risk, insurers would not worry to the same extent about exposure of deposit-insurance reserves to their operations.

Chairman **St Germain**. But that does not answer my question Professor Kane. Some of these brokerage houses are opposed to any meddling with brokered deposits; right?

Mr. **Kane**. Right.

Chairman **St Germain**. They tell us, after all. that they only put brokered deposits into institutions that are totally safe and sound. They say that they can monitor and analyze financial institutions to a degree where there should be no problem.

Mr. **Kane**. What I have said——

Chairman **St Germain**. Do you think that they have that capacity?

Mr. **Kane**. Answering your point more directly, what I tried to suggest is that Congress can require deposit brokers to put their money where their mouth is. Those that do undertake the research you mention should find it easy to warrant and bond their warranty in some way.

Chairman **St Germain**. What would the warranty be?

Mr. **Kane**. Well, essentially guarantee their analysis of the soundness of the receiving institution.

Chairman **St Germain**. They analyze an institution, examine brokered funds in that institution, and that institution, fails. What is the warranty?

Mr. **Kane**. They would be then responsible, according to the type of contract I envisage, to pay into the FDIC or FSLIC an amount of money tied to the amount of brokered funds they channeled into the failed institution. Their bill could cover as much as 100 percent of these deposits. It would be a matter of their showing us that they believe their analysis to the extent that they are willing to take a bath if they are wrong.

Anybody can claim to analyze things. The woods are full of touts telling us how to bet NFL football games. But these parties don't warrant their advice.

Chairman St Germain. I want to go to the other members and when I come back, I will ask unanimous consent that my questioning on the next round be placed in the record immediately following this questioning, because I want to go on with the other members of the panel on brokered deposits. But I want to first recognize my fellow members.

Is there objection? The Chair hears none.

Mr. Cooper.

Mr. Cooper. Thank you. I just would like to follow up on your line of questioning.

In looking at the testimony, it seems to me a fairly new approach, what I am proposing, Mr. Kane may have touched on it somewhat in his most recent remarks, the new approach would be, it is a way to increase the amount of money in the FDIC fund and the SLIC. The overall concept would be, today I feel that many of the people who enjoy the benefits of those insurance funds, by selling insured products, are not paying into the fund. In a sense they are free-riders on the system.

The solution, it seems to me, is to make every beneficiary of the fund pay some money into the fund, not just everyone who benefits, but anybody who benefits specifically commercially, by being able to sell or market that insured product.

I am referring specifically to brokered deposits. And, in particular, I would like Mr. Carron's and Mr. Silverberg's attention to this because it seems to me that the security house that markets the insured deposits does benefit from being able to market that deposit.

It is a good thing for that broker to be able to tell the scared customer, "Look, I have something here that you can purchase that is 100 percent backed up by the Federal Government," and yet you have the right today to market that without having to pay one dime into the fund that is insuring the money.

I realize that banks or S&L's are already paying a fee into the fund, but it seems to me that the security house also derives a substantial benefit. Certainly you would not want to forego being able to sell that insured CD or that brokered CD. You want the right to be able to continue to market that product, but yet I have never heard anyone mention you should also pay into the fund as a bank would or S&L would some pittance, so you can have the right to sell that product.

I would like to hear the reaction from someone in the securities industry like Mr. Carron to an idea like that, the user fee concept for the insurance fund.

Mr. Carron. As you point out, the deposits which are placed through brokers are subject to the annual deposit insurance assessment at either an FDIC-insured bank or FSLIC insured S&L, and that insurance premium is reflected in the rate which is made available to depositors whether it is done directly or whether it is done through a broker.

So, in that sense, the people who benefit are paying the fee.

Mr. Cooper. But not everyone who benefits is paying the fee.

Mr. **Carron**. The deposit on benefits as well.

Mr. **Cooper**. I am talking about the folks who have a measurable commercial advantage or interest in selling these things, and it seems that the brokerage house has just as much to gain commercially from being able to market that deposit as the bank or S&L itself would, yet you guys are able to benefit from it without having to pay anything right now.

Mr. **Carron**. If you were to impose a fee on this method of gathering deposits, then very likely it would disappear.

Mr. **Cooper**. It would depend on the level of the fee, wouldn't it, because they disappear from banks and S&L's, they are able to market these things quite successfully.

Mr. **Carron**. You would be imposing a new fee on top of the fee that would be charged.

Mr. **Cooper**. On the contrary, as I pointed out, your industry is not paying a dime right now so it is not a fee on top of anything from the standpoint of Shearson Lehman.

Mr. **Carron**. If you imposed a fee on deposits placed through brokers, that was not placed on deposits made directly into the institution, then brokered deposits would disappear.

Chairman **St Germain**. Mr. Cooper, may I?

Mr. **Cooper**. Yes.

Chairman **St Germain**. Mr. Carron, stop playing games with the committee. The brokerage house doesn't say go into brokered deposits because they are philanthropic; they get paid by the financial institution, that is usually a troubled institution or oftentimes a troubled institution. They pay a premium rate to the depositors. They also pay usually a half a point to the brokerage house; don't they?

Mr. **Carron**. There is a fee. I am not arguing that.

Chairman **St Germain**. Of course there is a fee. Please, you are a brilliant man. I think that is what Mr. Cooper is getting at. Why doesn't the brokerage house pay half that fee to the FDIC or the FSLIC?

Mr. **Cooper**. It is a simple user fee concept. It surprises me that a member of the security industry could come before the subcommittee testifying about reform and not consider the fact that your industry itself may have an obligation or duty out there to help keep the fund solvent since you are benefiting from the existence of fund. I have yet to meet a broker who would like to dispense with his ability to sell that product or market the brokered CD.

So I am not asking you to commit Shearson Lehman today, but I would ask you to look into that and to consider along with the other various reform proposals.

I would like to ask Mr. Silverberg if he would—an FDIC representative testified last week, I believe, that he had never considered the idea before. I would like to ask the FDIC to consider it and if possible to estimate how much money it would be practical to bring in by using a fee device like this, assuming that brokerage houses would pay a fee comparable to that levied on banks and S&L's.

Mr. **Silverberg**. I must admit it is an idea that I have not been exposed to either. It does seem interesting.

I must also admit I am more swayed by Professor Kane's approach, which would somehow impose the cost or allocate a portion of the insurance loss to the broker for those institutions that in fact do fail, where brokered deposits are present.

Mr. COOPER. I was trying to think of the simplest, easier type of device. This is one that is already in practice and I am not sure of all of the ramifications of Mr. Kane's idea. It would least happen after the fact, after the failure. I am interested in bolstering the fund before people wonder whether the fund is going to be big enough to pay for all the losses or not.

Mr. KANE. Most of us discipline children by letting them know if they do certain forbidden things, a specific set of unpleasant consequences will follow. To make these threats credible, when and if children do bad things, we must go on to spank them or otherwise penalize them after the fact. In this way, an after-the-fact penalty can still exercise before-the-fact restraint.

You are right in saying that the deposit-insurance industry, as the Chairman pointed out, shifts some of its subsidy to the brokerage industry. That is an essential and undeniable point. It doesn't matter whether the banks pay a nominal insurance fee on the funds that deposits brokers provide. What matters is how risky is the use to which these funds are put.

To the extent an institution is running a very risky operation, it is extracting excess value from its insurers. The market tries to spread this excess value around. As long as a subsidy exists, the deposit brokers get their cut.

Mr. COOPER. I am anxiously awaiting the first brokerage house to volunteer to pay part of the fee.

Thank you.

Chairman ST GERMAIN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Silverberg, I understand that one of the main aspects of your testimony is to provide better capitalization of financial institutions. That is a major part of the solution dealing with depositor insurance.

Mr. SILVERBERG. Yes, I believe it is. It is not going to prevent all bank failures, and I think the problems of the deposit insurance system are not the principal reasons why we have had more bank failures over the last several years. But I think over the long run that higher capital requirements, combined with a higher threshold at which regulatory pressure comes into play, will tend to reduce the number of failures, and also tend to not have the FDIC handle most failures. In fact, most institutions that get into difficulty will end up being handled as most institutions that get into difficulty in other sectors of the economy do; they sell out to somebody else or find a solution that doesn't involve a government agency.

Mr. VENTO. I presume that this is applicable to the FDIC and FSLIC insured institutions, not as an example of a working model for a privately insured institution, for instance, in Ohio or Maryland; is that right?

Mr. SILVERBERG. Right.

Mr. VENTO. And why is that?

Mr. **Silverberg**. Well, I suppose, if I thought that Maryland or Ohio were workable operations, there would have been a possibility there too, and I suppose one could clearly make the case that, say in Maryland, the fault is that the threshold of regulatory pressure did not come into play at the appropriate time.

I am not sure that in the case of Maryland that there was the financial strength, and backing to absorb the losses, if the institutions could not find a private sector solution.

Mr. **Vento**. I mean, it seems obvious to me that this particular solution would result in less regulatory involvement.

If you look at banks and they have a higher capital, that means there is more of an insulating effect. But the fact is that that in and of itself would not be very meaningful unless one were to look closer at the nature of the portfolio; isn't that accurate?

Mr. **Silverberg**. That is correct. It still becomes very important that the examination process goes on. There is substantial reporting today in terms of loan quality and so forth, but that process has got to be supplemented with examinations. Capital by itself doesn't mean anything unless you have a good sense that the bank is appropriately charging off those assets that ought to be charged off.

Mr. **Vento**. Well, this sort of takes me into the testimony that Mr. Carron offered—maybe it has been offered also by Mr. Kane—and that is this question of forbearance by the insurance agencies, in a sense; that is the forbearance issue.

So in those instances, irrespective of what the capital is, if for instance there is forbearance in terms of how they are managing their portfolio, therefore forbearing on energy or foreign debts, or, for instance, agriculture, in the 1980's, I don't know what it will be in the 1990's, if they are, how do you respond to that? Is the regulatory agency complacent in providing for forbearance in these institutions? What recommendations are there to deal with that? How does this affect forbearance?

Mr. **Silverberg**. Well, ideally forbearance shouldn't come into play. We all may have different judgments as to whether the agencies have been forbearing or not, or how tough the Federal or State banking agencies have been or how tough the banking supervisors versus the savings and loans supervisors have been.

I would agree that fairly tough enforcement policies and fairly tough standards on loan writeoffs, are essential ingredients in implementing the capital proposal we are talking about.

Mr. **Vento**. Mr. Silverberg, how significant is the insurance agencies in terms of the regulatory role here? Are they really, in a sense, in terms of protecting the fund, overriding other types of bank examination, or other aspects by virtue of their activity, or are you relied upon, in other words, simply in terms of protection of the fund? Doesn't this really kind of drive the other agencies?

Mr. **Silverberg**. As you know, the FDIC directly examines nonmember institutions. We do have an ongoing program of joint examination with the comptrollers of the currency that has just been in place a relatively short period of time. We are developing a system with the Fed.

A part of the examination process is to determine the condition of the bank and its solvency. When a bank approaches various degrees of weakness, certain enforcement actions are taken.

What I am suggesting perhaps is that the level at which those actions are taken come in slightly earlier; that is, the threshold at which you make demands for additional capital or require corrective actions be made at an earlier stage so that the institution still has some value and still has some options. If we wait too long, or if bank management waits too long, very often there aren't very many options.

Mr. Sexton alluded to the fact that in the process there are in fact a lot of success stories, where examiners do come in and do put pressure on institutions that are able to take corrective actions and survive.

Mr. VENTO. Mr. Kane, do you think this is part of the problem, the greater involvement of regulatory standpoint, and therefore should we be expanding the universe of what is covered by the insurance and expanding the amount that we take in or trying to limit it?

Mr. KANE. Well, the question is, Who is to provide the discipline? If you plan to provide discipline entirely from the regulatory side, then of course the response system that regulators plan to use becomes key. To the extent thay you expect depositors or other uninsured creditors to provide discipline, you must concern yourselves with the adequacy of these parties' information and response system.

In principle, the system could work either way. My concern is the same as Mr. Sexton's. I doubt that we can rely on government employees and government systems to solve the problem. I am more comfortable with relying on private sources to supply this kind of discipline.

You mentioned the forbearance issue. Regulatory forbearance is central to the deposit-insurance subsidy in that institutions that are insolvent de facto are allowed to play in what we may call the casinos of finance with government money. They are encouraged by the fact of their insolvency to take enormous risks. Taxpayers and deposit insurance agencies have asymmetric claims against the results of those bets. If the institution wins, it gets to keep the overline. If the institution loses, it just adds the new loss to the costs that the insurance agency has to pick up.

Mr. VENTO. The point is that just to put this into better focus for the action and increase risk-related basis or proceed to go to other types of industries that have relations with banklike broker deposits, aren't we in essence weighing in on the side of regulatory solutions?

Mr. KANE. The question is what those parties will demand in the way of information flow and rights of response. For instance, if we ask deposit brokers to conduct a financial analysis of the institutions they service and warrant this analysis with their own funds (that is to say that if they are wrong and their client fails, they are going to pay a monetary penalty), they are going to demand information from the institutions that isn't part of the ordinary information system in place today. They are going to want to control their own risks that——

Mr. **Vento**. Or be collecting more money, I guess, and risk-related deposits or on expanding it for insurance through brokered deposits or other ways.

Mr. **Kane**. Well, one reason for setting risk-related premiums is the hope of changing the risk-taking that occurs. If the risk-taking is reduced sufficiently, less money might actually change hands.

Mr. **Vento**. It is a kind of balancing act.

Mr. **Kane**. Yes, a balancing act, but speaking realistically the fees collected have been so very low relative to the risks outstanding today that I would guess that we are talking about collecting additional funds.

Mr. **Vento**. I appreciate the chairman's forbearance.

Chairman **St Germain**. Mr. Silverberg, if under the ideal scenario, the suggestion about increased capital and subordinated debt and so forth, were to be adopted, would this mean that you would reduce the number of examiners at the FDIC? You won't have to examine with such frequency. Would the task of the regulator be lessened substantially, or would it be the same? Would you have the same process as you have now with the same number of examiners, et cetera?

Mr. **Silverberg**. I think over the long run, the answer would be somewhere between same and somewhat less or somewhat fewer. I think there is a general perception in the FDIC and other agencies that we are behind in terms of the numbers of examiners today, and that we are in fact in a catch-up mode. Starting where we are today, we need to expand our examination force.

I think over the long run, if this capital proposal were in place and phased in, it would probably require somewhat fewer examiners.

Chairman **St Germain**. Mr. Silverberg, when an examination is made of an institution the size of Chase, Citicorp, Continental Bank of America, how many examiners usually go into these mammoth institutions when the examination is in progress? Do you know?

Mr. **Silverberg**. I would like to see if Mr. Sexton has a better idea. Mine would be more of a guess.

Mr. **Sexton**. Not as many as one would think. I suspect sending 75 examiners into an institution like that would get it started then. There are various functions that are examined at various times, and so you have these people leave and other groups come in.

Chairman **St Germain**. My memory is usually pretty good. I remember Professor Kane being here in December 1975. I remember other things like testimony before us that Bank of America required 150 to 200 examiners. You mean I am way off on those numbers?

Mr. **Sexton**. Not at one time. I think that, yes, you would have that many people coming in and looking at the institution, perhaps more.

Chairman **St Germain**. How long does an examination of a Bank of America, Chase or Citicorp take?

Mr. **Sexton**. Probably 6 months.

Chairman **St Germain**. Mr. Silverberg, you know, here is a little something that bothers me. Do you remember Franklin National Bank?

Mr. **Silverberg**. Very well.

Chairman **St Germain**. So do I. Do you recall the circumstances of the failure and the reasons that were given to us and this committee for the failure?

Mr. **Silverberg**. I don't recall what it——

Chairman **St Germain**. Let me refresh your memory, because it was fascinating. A tremendous number of examiners were in there and they had already left that phase of the operation where they were dealing in Eurodollars and Eurofunds, go on to other areas of Franklin National, and lo and behold after they had departed and obviously said everything is fine here, a month or so later they are still in Franklin National on examination. All of a sudden the place tumbles down. The examiners had to scurry so they would not get hit by falling plaster.

That is what happened in that institution. That is why—this is a followup to my question to you. If you were to adopt that which you have stated, you would adopt—would this indeed lessen the task and the problems of the regulators? And that concerns me because I think Mr. Carron's testimony stated that he felt there was a shortage of personnel; that we had to beef up a little more.

Mr. **Silverberg**. I agree with that.

Chairman **St Germain**. We won't pursue it any further, but we will have it in the record, the fact that this particular member is concerned. Even though we were to adopt all kinds of reform, we still have got to have a good examining force.

Mr. **Silverberg**. Yes, I think we all agree to that.

Chairman **St Germain**. Professor Kane, we heard Mr. Sexton say that there were S&L's in Texas that were paying a higher rate of interest on their deposits than the commercial, and that this posed a problem competitively. Are you familiar with some of the investments that are permitted S&L's in Texas and in California? Have you taken a glance at that?

Mr. **Kane**. I have read about this problem in the newspapers, but the details didn't stick in my mind. I know that these firms are able to enter into various joint ventures freely.

Chairman **St Germain**. And they invest in all kinds of things for the insurance, as you will recall.

Do you remember a fellow named Knapp, with the Financial Corporation of America? He was taking over, according to—Jim Robinson came in to see me, Mr. Carron. He told me Knapp was going to take over Shearson/American Express.

Mr. **Carron**. He was going to take over the parent, American Express.

Chairman **St Germain**. He was taking a substantial position. That is not why we in the Congress who have supported the thrift industry have done so. We supported the thrift industry so they could make home mortgages, not go into the stockmarket and speculate on it.

Do you feel it is proper for the State-chartered institutions in California and Texas, as well as in some other States, to go into some of these most unusual activities? In one State, one S&L, I think, has a firm that manufacturers pots and pans. Is that closely related? Should we allow these wild things to happen, Professor Kane?

Or should there be limitations on the areas they invest in if we, the Federal Government taxpayers, are going to insure these State-chartered institutions? You see, the federally chartered institutions in those States are not allowed to do what the State-chartered institutions are doing.

Mr. **Kane**. You put your finger on the major points. If Federal taxpayers are insuring what these firms are doing, they have an economic interest in Federal bureaucrats controlling the risks these firms take. We find ourselves confronting once again the point that the risk-management systems that Federal deposit insurers currently use is inadequate.

I wouldn't want to forbid firms from engaging in risky activities, so much as make them pay the freight for the load these activities put on their deposit-insurance company. If an insured S&L thinks it would be profitable to deal in pots and pans, so be it. If that is what——

Chairman **St Germain**. Manufacture them.

Mr. **Kane**. Manufacture them, wholesale them or whatever.

Chairman **St Germain**. I am glad Mr. Carper is here so he can relate this to some other members of the subcommittee and full committee who aren't here.

Mr. Carron, what is your opinion about S&L's in California, State-chartered S&L's being able to go into all of these unusual fields?

Mr. **Carron**. I think it is inappropriate. I think that it is inappropriate for State legislatures to allow institutions to get into investments knowing full well that it is not the State that is going to have to pick up the pieces if something goes wrong. It is all going to fall on the Federal Government, so I am completely in agreement with Ed Kane on that.

Chairman **St Germain**. Mr. Sexton, I know this might be difficult for you, but the fact of the matter is that if S&L's in Texas are allowed to invest the way they do, in oil rigs, real estate development, and so forth, then when they get in trouble they go out and glean brokered deposits, they should pay a premium for that.

And I might say that I don't think Shearson/American Express does much in the brokered deposit field. Do you, as a gentleman who is concerned about the viability and stability of the commercial banking system, in Texas, feel that there should be another look taken, if not at the State level, at the Federal level so that we can exercise a little more control over which activities S&L's can engage in, in the State of Texas, so we protect the FSLIC insurance fund?

Mr. **Sexton**. I am not at all sure I completely agree that all the activities in the generic sense are risky.

Chairman **St Germain**. I am not saying that they are all risky, but by the same token the States of Texas and California allow these S&L's to go into areas that federally chartered institutions are not allowed to go into. Since the Federal taxpayer is the one at risk here, shouldn't it be the Federal regulator that sets boundaries, along with the Congress?

Mr. **Sexton**. Well, there has been a lot of innovation occur in the States and I think the State regulatory legislative framework has provided a lot of impetus for needed change in the industry. So I wouldn't advocate doing away with the State's ability to set powers.

I think that the absence of powers in banks is just as bad as the perhaps excess of powers in the thrifts in some of the States. I think there is a happy medium there, but underlying all this is the legitimate concern that if you are going to engage in these powers, at least have the ability to answer for your mistakes.

As Dr. Kane pointed out, it is a one-sided deal. They win, they win. They lose, we lose. We, the Federal Government.

Chairman St Germain. Let me ask you, Mr. Sexton, to give me an update, a progress report. I think there was consideration in Texas of a private insuring fund there for the S&L's, and the thrift industry.

Has that progressed any, do you know?

Mr. Sexton. Yes, sir. It was passed and what that really constituted was a program where the thrifts would be bailed out by their own kind. If they got into trouble, they would basically underwrite the FSLIC.

They didn't replace the FSLIC. They promised the FSLIC they would underwrite their own losses to a certain extent, provided the Bank Board relieved the S&L's in that State of Bank Board restriction concerning capital and limitations on joint ventures and certain other things the S&Ls found a little bit confining.

Chairman St Germain. Did that legislation pass in such a manner—is it still a call on the industry to bail out or are they actually paying into a fund? Because as I recall it—I could be wrong, Mr. Sexton—as I recall it, initially the proposal was that there would be a fund, but without any money in it.

It would be a call on those institutions after the fact, hoping that they would be able to come up with the money beforehand. Is that the way it eventually was passed or was adopted?

Mr. Sexton. I will have to admit, Mr. Chairman, I didn't follow that legislation terribly close, but I believe there is some hard money upfront. But it only becomes effective if the Congress recognizes the validity of that approach and does indeed relieve the S&L's in Texas from certain regulations that the Bank Board has proposed. But there would be hard funds.

Chairman St Germain. You know what would be great? If the legislature of the State of Texas would decide that they insure the S&L's there and get out of the FSLIC. They could do anything they would like to do. That is States rights to the fullest extent; correct?

Mr. Sexton. If you will spare me from responding to that I will appreciate it.

Chairman St Germain. Mr. Carper.

Mr. Carper. Thank you, Mr. Chairman.

Welcome to each of the panelists. I particularly want to welcome Dr. Kane.

Speaking as an Ohio State graduate, it is a pleasure to have you back before the subcommittee. I would like to start off, if I could, by directing a couple of questions to Mr. Sexton. I would like for you, if you would, sir, just to describe briefly for me how the banking department in the State of Texas coordinates with the Federal regulators of banks in terms of supervising banks in Texas.

Mr. **Sexton**. We have an excellent working relationship with the FDIC because I spent a lot of years there. I know what they are capable of; they know what we are capable of.

The working relationship is the same basically with the Fed and we have less occasion to work with the OCC. The FDIC had designed a working relationship with Texas where they would examine the banks this year and we would examine them next year and we would swap lists.

That went on for about 2 years and the FDIC dropped out of the arrangement, not because they were unhappy with it, but they had decided they would go examine some national banks, as you recall, fairly recently.

So we have the majority of the regulatory load in Texas on the clean banks, on the one and two rated banks. On the threes, fours and fives under the CAMEL system, which are the problems and the near problems, the FDIC in the State of Texas will, 90 percent of the time, go together and put our programs in together.

If I decide to take my action they will sign it. If they take their action under the cease and desist powers, I will sign it. So we have had very little disagreement on the program for rehabilitation of a financial institution and we worked together every step of the way.

I talk on the phone to each of those agencies at least once a day.

Mr. **Carper**. So when a bank enjoys a CAMEL rating of one or two, they are for the most part regulated or supervised on an annual basis by your office; is that correct?

Mr. **Sexton**. Yes, sir; that is correct. The examination priority followed by the FDIC says they won't necessarily need to go into those banks except once every 3 years and with a good excuse they can stretch it out further than that.

So our statutory mandate is once every 18 months. So we basically regulate those institutions and they rely on us for that along with their monitoring systems.

Mr. **Carper**. So the burden of determining whether a bank continues or should continue to enjoy a one or two rating under the CAMEL system falls to your office; is that correct?

Mr. **Sexton**. Falls to me initially. We provide the FDIC with a copy of every examination we do. If they disagree with us they are the master recordkeeper around the Nation on all banks.

If they disagree with us they will call us and say that we believe this bank to be a three where you said it was a two and we will argue over the telephone and we will settle it one way or the other, but they do see my product in every instance, every memorandum I do on a visit with the Board they get. Every thought that I have about that bank goes into a memorandum and they get it.

So we keep them up-to-date even though we are the ones on site and are the ones most directly involved in regulating the clean institutions.

Mr. **Carper**. I was recently talking, I think, with some bankers from Delaware who explained to me that legislation—we were talking about some legislation that had been enacted in Delaware at their request. The legislation that was enacted was legislation raising the fees that they pay in order that the State bank commissioners could increase the salaries that are available to State examiners. I think a beginning salary of $13,000 was mentioned to me.

That was the salary that existed prior to the adoption of this legislation this year. It has now been raised, I think, to 18, and it tops out at several times that amount.

I guess the question I have to ask of you is in terms of salaries that are available for you to pay to the people that work for you and do the supervision, what is the range? What is the source of the funds for those salaries and is it adequate to retain quality examiners?

Mr. **Sexton**. I can't tell you it is adequate because our turnover rate is about 33 percent. Most of that flows from the fact that the holding companies around Texas are building their own quality control teams to act as internal examiners and they have come to the State, they have come to the Fed, and they have come to the OCC basically to get those people. The FDIC seems to keep their people happier and their turnover rate is a little less, although it is higher in Texas than elsewhere.

The starting salary is competitive with the Federal people. Our starting salary is just a shade less than 20. A bank examiner in the field can go to approximately $43,000.

It gets fairly competitive at that top level but to get up to 38, 39 is not difficult, I should say, providing you have the time and you have the expertise to justify that kind of salary. We believe we are competitive.

We believe that our loss of people arises from a traditional thinking that you come with a banking department to stay 5 years and you go find a job. That is the way it has always been structured, plus the fact that the holding companies are very tenaciously——

Mr. **Carper**. Let me interrupt by a quick question. You say people stay 5 years and then they go out and find another job. We have heard from other regulators who have testified before the subcommittee that it usually takes 3 to even 5 years to train somebody.

Mr. **Sexton**. It takes about 3 years for a person with good inherent skills to become an effective bank examiner in my estimation. That is the minimum. By then you do have $15,000 to $20,000 in hard training costs.

We pursue training vigorously in Texas to get our people up to speed as quickly as possible. But there is no doubt about it, a 5 year man is getting to where he is just the kind that you need to go out and knock heads at the problem bank; then we lose him.

We have taken some measures recently. We have created ten new high level positions in our department last month and are filling those with experienced people now to strengthen ourselves in that regard.

Mr. **Carper**. Dr. Kane.

Mr. **Kane**. I would like to comment on this.

I think one of the biggest causes of examiner turnover is the lifestyle burdens of the job: the amount of travel involved and the time spent away from home and friends. Much of examiner turnover is keyed to the life cycle. As individuals mature, they generally want to settle down. In a State such as Texas, an examiner's average distance from home can be fairly large. If we move toward automating the process and performing more in the way of electronic examinations, we would raise the skill levels of the examiner work force. This would require us to pay them more, but emphasizing automation and remote examination may do more to reduce examiner turnover than the mere creating of higher-salary jobs. It is psychologically difficult to live most of one's life away from one's home, especially when one must operate in an unfriendly or adversarial environment. Bankers seldom welcome the examiners.

Mr. CARPER. My time has expired. Thank you.

Mr. St Germain, thank you.

Chairman ST GERMAIN. Thank you. I would comment, however, that one of the reasons, I think, for a lot of the travel is that you don't want the same examiner examining the same institution time after time after time because of the inherent problems that can arise. I have had testimony on this, and I have had people from the agencies talk to me in private. They ask: What do you do when you are a 25-year-old examiner and then all of the sudden you are talking to a Charley Knapp, for instance, who, you know, is a very strong-willed, tough son of a gun. Then it is quite a burden to say, hey, Mr. Knapp, I think you have done something wrong here. What do you mean I have done something wrong, he will ask. So this question with the examiners is a very difficult one and we appreciate it.

Mr. Sexton, back a few years ago I went to San Antonio, TX, and I had a little hearing on Carrizo Springs. Do you recall Carrizo Springs?

Mr. SEXTON. Yes, I do.

Chairman ST GERMAIN. Did you ever examine that place when you were with the FDIC?

Mr. SEXTON. No, sir. That was a little bit out of my territory.

Chairman ST GERMAIN. This is fascinating, Mr. Carper, because it was headed up by a chap named Enrique Salinas—talk about unusual loans. He lent money to his wife for a window air-conditioner that was in secondhand condition when they bought it. He also lent her money so she could buy a 25-percent interest in a Mercedes automobile that was about 12 years old at that time. The amounts were rather substantial in both instances.

Suffice it to say, that Carrizo Springs ended up without the Carrizo Springs Bank but that was only after a long, tedious process.

Mr. Silverberg, let me ask you this. There were how many bank failures last year?

Mr. SILVERBERG. Seventy-nine, I believe, was the number.

Chairman ST GERMAIN. Does FDIC classify them or keep a record of how many there were per individual State?

Mr. SILVERBERG. Yes.

Chairman ST GERMAIN. Do you know which State was sort of, you know, the all-star?

Mr. SILVERBERG. I would have to go back. In fact, I can submit for the record a couple of internal pieces that were written on the regional distribution of failures. A year or two back, of course, Tennessee had the most failures.

Chairman ST GERMAIN. Right.

Mr. SILVERBERG. We seem to be moving more in the direction where the farms, the Midwestern Farm Belt and, of course, in Oklahoma which has both energy and an agriculture problem, has been high on the list.

Chairman **St Germain**. OK. Now that information you prepared, do you know how far back it went?

Mr. **Silverberg**. Well, I am sure we covered the last 3 or 4 years where the numbers of failures have been fairly high, but we could, of course, go further back.

Chairman **St Germain**. It wouldn't be all that difficult.

Mr. **Silverberg**. That is correct.

Chairman **St Germain**. Would you go back 10 years for us and submit it for the record, please?

Mr. **Silverberg**. Sure.

[In response to the request of Chairman St Germain, the following information was submitted for the record by Mr. Silverberg:]

BANK FAILURES AT FDIC-INSURED INSTITUTIONS, BY STATE
1975-1985

	1985*	1984	1983	1982	1981	1980	1979	1978	1977	1976	1975
Alabama	2	1	1	1	-	1	1	3	-	-	-
Arizona	-	-	-	-	1	-	-	-	-	-	1
Arkansas	1	2	1	3	-	-	-	-	-	-	1
California	5	6	5	2	-	-	-	-	-	1	-
Colorado	5	2	1	-	-	-	1	-	-	2	-
Connecticut	-	-	-	-	1	-	-	-	1	-	-
Florida	1	2	-	1	-	1	-	-	-	-	-
Georgia	-	-	-	-	1	-	1	-	1	1	-
Illinois	2	5	6	5	2	1	2	2	-	-	1
Indiana	-	2	-	-	-	-	-	-	-	-	-
Iowa	9	3	-	2	-	-	-	-	1	-	-
Kansas	10	7	1	-	-	3	1	-	-	-	1
Kentucky	-	1	1	-	-	-	-	-	-	1	-
Louisiana	-	1	-	-	-	-	-	-	1	1	-
Massachusetts	-	-	-	1	-	1	-	-	-	1	1
Michigan	-	1	-	1	-	-	-	-	-	-	-
Minnesota	4	4	1	1	-	-	-	-	-	-	-
Mississippi	-	1	-	-	-	-	1	-	-	-	1
Missouri	4	2	1	2	-	-	-	-	-	-	1
Montana	-	-	1	-	-	-	-	-	-	-	-
Nebraska	9	5	1	-	-	-	-	-	-	-	-
Nevada	-	-	1	-	-	-	-	-	-	-	-
New Jersey	-	1	1	1	-	-	1	-	-	2	-

	1985*	1984	1983	1982	1981	1980	1979	1978	1977	1976	1975
New Mexico	2	-	-	-	-	-	-	-	-	-	-
New York	2	-	2	4	3	-	-	-	-	1	-
North Dakota	-	-	-	-	-	1	-	-	-	-	-
Ohio	-	-	-	-	-	-	-	-	-	-	1
Oklahoma	7	5	1	3	-	-	-	-	1	-	-
Oregon	3	5	5	-	2	-	-	-	-	-	-
Pennsylvania	-	-	-	1	-	-	-	-	-	1	-
South Dakota	-	1	1	-	-	-	-	-	-	-	-
Tennessee	4	11	12	3	-	1	1	-	-	1	-
Texas	8	6	3	7	-	-	1	-	-	4	2
Utah	-	1	-	-	-	-	-	-	-	-	-
Virginia	-	-	-	1	-	-	-	-	-	-	-
Washington	-	-	-	1	-	-	-	-	-	-	-
West Virginia	-	1	-	1	-	1	-	-	-	-	-
Wisconsin	1	-	-	-	-	-	-	-	-	-	2
Wyoming	3	2	1	-	-	-	-	-	-	-	-
Puerto Rico	-	1	1	1	-	-	-	2	1	-	-
Virgin Islands	-	-	-	-	-	-	-	-	-	-	1
TOTAL	82	79	48	42	10	10	10	7	6	16	13

*Through September 30, 1985.

NOTE: STATES NOT LISTED ABOVE HAD NO BANK FAILURES DURING THIS TIME.

Chairman St Germain. Gentlemen, we have a number of questions here that the staff and I worked up, but we are going to be very kind and rather than go through them here at this point in time, we are going to submit them to you in writing and ask you to reply to us.

We want to express our deep appreciation to all of you for your appearance.

Professor Kane, you live up to your reputation at all times, but you have to admit that we put you in with some real excellent witnesses today, because we didn't want you to outshine anyone.

Mr. Kane. Thank you for the compliment and for putting me in such good company.

Chairman St Germain. Thank you, gentlemen.

The subcommittee will stand in recess until tomorrow morning.

[Whereupon, at 1:15 p.m. the subcommittee recessed, to reconvene the following day, Thursday, September 19, 1985.]

[Letters of invitation to witnesses of this day's hearing follow:]

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TOBY ROTH, WISCONSIN

September 10, 1985

Dr. Andrew Carron
Mortgage Securities Group
Shearson Lehman Brothers, Inc.
55 Water Street
New York, N. Y. 10041

Dear Dr. Carron:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on September 18, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

1. Modified Payoff
2. Subordinated Debt Capital
3. Risk-related Deposit Insurance Premiums
4. Risk-related Capital Requirements
5. Insurance Fund Recapitalization
6. Insurance Fund Merger
7. 100% Deposit Insurance Coverage
8. Reduced Deposit Insurance Coverage
9. Greatly Instensified Supervision
10. Market Value Accounting
11. Private Deposit Insurance
12. Brokered Deposit Restrictions

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building twenty-four hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing record, and if delivered when requested, the statement will be made available to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to ten minutes.

Sincerely,

Fernand J. St Germain
Chairman

FJStG:dDv

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STEVE BARTLETT, TEXAS
TOBY ROTH, WISCONSIN

September 10, 1985

Hon. James L. Sexton, Commissioner
Texas State Department of Banking
2601 North Lamar Street
Austin, Texas 78705

Dear Commissioner Sexton:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on September 18, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

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Sincerely,

Fernand J. St Germain
Chairman

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STEVE BARTLETT, TEXAS
TOBY ROTH, WISCONSIN

September 10, 1985

Dr. Edward Kane
Professor of Banking
The Ohio State University
1775 So. College Road
Columbus, Ohio 43210

Dear Dr. Kane:

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Fernand J. St Germain
Chairman

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TOBY ROTH, WISCONSIN

September 10, 1985

Mr. Stanley Silverberg, Director
Division of Research and Strategic Planning
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Mr. Silverberg:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on September 18, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

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Sincerely,

Fernand J. St Germain
Chairman

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FINANCIAL CONDITION OF THE BANK AND THRIFT INDUSTRIES

THURSDAY, SEPTEMBER 19, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
SUPERVISION, REGULATION AND INSURANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the subcommittee) presiding.

Present: Chairman St Germain: Representatives Barnard, Oakar, Schumer, Kaptur, Wylie, McKinney, Dreier, and Parris.

Also present: Representative Thomas R. Carper, from the full committee.

Chairman ST GERMAIN. The subcommittee will come to order.

This morning we continue the subcommittee's hearings on deposit insurance reform with the testimony of Catherine England, John Kareken, George Kaufman, and David Pyle. Each of these witnesses is an acknowledged expert on deposit insurance reform. Their testimony will be of great help to us in our examination of the role of Federal deposit insurance and of the need for modification in the existing deposit insurance system.

Our first witness this morning will be Catherine England who is a senior policy analyst at the Cato Institute. We will put your entire statement in the record. You may proceed.

STATEMENT OF CATHERINE ENGLAND, SENIOR POLICY ANALYST, CATO INSTITUTE

Ms. ENGLAND. Thank you, Chairman St Germain.

I would like to thank you and the subcommittee for the opportunity to testify today.

I think reform of the deposit insurance system is crucial to the future stability of the Nation's depository institutions. Further, I think deregulation is necessary primarily from a safety and soundness point of view. I think we have to increase the flexibility and adaptability of our depositories as we move into a world of increasingly interdependent financial services.

Unfortunately, deregulation is incompatible with the current system of Federal deposit guarantees. A Government guarantee of deposits undermines market discipline by making all insured deposits—whether held by well run or poorly run institutions—essentially the same. The present flat-rate deposit insurance premium compounds the problem by subsidizing the Nation's riskier depositories.

While deregulation is necessary to preserve the long-run viability of the Nation's depositories, Federal regulation and supervision are necessary as long as deposits are federally guaranteed. We must, therefore, find another way to protect small depositors. I believe at least part of the answer lies with private deposit insurance.

The survival of the private insurer depends directly on his ability to accurately assess and control the risk undertaken by the institutions he insures. Therefore, we should expect private guarantors to set high standards for the institutions they agree to insure, to insist on frequent financial reports designed to identify changes in an insured institution's condition, to conduct on-sight examinations when necessary, to monitor changing national, regional, and local economic conditions in an effort to anticipate and offset cyclical problems, and to develop effective means of controlling the risk undertaken by a particular bank or S&L. That control might involve developing risk-related premiums or insisting on the right to preapprove any major business decisions.

In fact, I think a critical flaw in both the Ohio Deposit Guarantee Fund and the Maryland Savings Share Insurance Corp. was their reliance on State regulators rather than their own, to oversee and discipline the managers of the savings and loans they insured.

Rather than setting hard and fast rules, however, private guarantors would have the flexibility to deal with each bank's request to expand service on a case-by-case basis. When making a decision, the private insurer could consider the skill and experience of the managers, the general economic health of the institution and the region in which it operated, and whether the proposed expansion complemented other facets of the bank's operations.

Ultimately it is in the best interest of private guarantors to promote individually sound and healthy institutions. But despite these potentially important advantages, the potential transition costs in moving to a system with private guarantees raise several important questions. Private deposit insurance remains in its infancy; it needs time to develop.

Many consumers would be extremely uncomfortable if they were asked to give up their Federal guarantees, but I believe there is a way we can introduce private guarantees and allow consumers, depositors, actually to choose how fast and how far deregulation and private deposit insurance develops.

Suppose each bank could choose among several deposit insurance plans. At one extreme, a bank might be allowed to insure 100 percent of its deposits, extending explicit protection beyond that available today. In return, however, the bank would be subject to extensive Government regulation: stringent capital requirements, high reserve requirements, strict controls over the range of its assets, restrictions on the types of liabilities it could offer, and restrictions on its ability to branch. At the other extreme, a bank would be allowed to choose to provide no Federal insurance for its depositors. In that case, it would be subject to no Federal regulation of its activities.

Such a plan would also need intermediate options. These could take a number of forms, but let us suppose for the sake of exposition that tiered deposit insurance would be patterned on the current system. In addition to the two extremes, banks would be offered deposit guarantees that covered, say, the first $100,000, the first $50,000, or the first $10,000 of each deposit.

As a bank chose to provide less Federal insurance coverage for its depositors, and the Federal Government's potential liability was consequently reduced, the bank would be subject to correspondingly fewer Federal regulations.

The manner in which regulations are removed as an institution elects to provide a lower "tier" of Federal insurance is not as important as the fact that as a depository accepted less Government insurance, it would operate in a progressively less regulated environment.

Banks would, of course, be required to display information about the amount of Federal insurance they offered and to ensure their depositors understood how far their Federal guarantees extended. Then we might see a wide range of banks, some catering to retirees and other individuals who found the safety and the immediate availability of their funds extremely important.

Other less conservative consumers might opt for less Federal insurance because geographic accessibility was more important to them, or because the convenience of one-stop financial shopping ranked high on their list of desirable bank characteristics. Indeed, any one consumer or family could place deposits in several institutions.

Under a system of tiered Federal deposit insurance, bankers could have broader powers and greater freedom only if they were able to win the confidence of those depositors who subsequently sacrificed some or all of their Federal guarantees. Bank managers who wished to pursue a less regulated route could no longer do so by assuming the Federal Government would be there to pay the bills should things go wrong.

I believe this system would reduce the probability of system-wide failure. No one could have foreseen the economic and technological upheavals that occurred during the 1970's and early 1980's. Similarly, no one can predict from where the next financial crisis will come. Consequently, any regulatory system that makes decisions for all depository institutions places all institutions at risk if events unfold in an adverse manner.

A tiered system of deposit insurance, on the other hand, would have the advantage of creating wider diversity among the Nation's financial institutions.

Runs are a danger when depositors view all banks as being fundamentally the same and, as a result, subject to the same weaknesses. To the extent consumers come to look on depositories as a diverse set of institutions, exercising widely varied powers, problems at one bank are more likely to be viewed as unique to that institution and the danger of systemwide failures is reduced.

Finally, in accordance with the subcommittee's request, I will comment briefly on the 12 proposed reforms.

First, modified payoffs. Any change that introduces more market discipline into the system will ultimately strengthen it in my view, but I am concerned that depositories of different sizes would be treated unequally, with decisions based on the size of the institution involved. That could actually encourage concentration within the industry.

Subordinated debt capital is also a good idea as long as we don't apply one rigid rule to all institutions and force them all into the debt market at the same time.

Risk-related deposit insurance premiums and risk-related capital requirements should not be administered by a federally sponsored, monopoly supplier of deposit guarantees.

I am concerned that premiums would be based solely on objective criteria without considering the equally important subjective information, for example, the ability and experience of the bank's management, the economic health of the local community, et cetera.

Further, revising the formula would be very difficult as it becomes obsolete through technological changes and bankers' innovations.

Insurance fund recapitalization is probably necessary in the long run, but the immediate recapitalization of the FSLIC would only mask underlying problems and delay a reckoning that must come.

Similarly, an insurance fund merger would only mask the existing problems and not deal with the underlying issues that must be dealt with.

A 100-percent deposit insurance requirement would reduce the market incentives to monitor the industry and require increased Federal oversight rather than less.

Reduced deposit insurance coverage should be an option available to bankers, I believe, but fewer Federal guarantees should be accompanied by reduced Federal regulation.

Greatly intensified supervision. A Federal commitment to more closely supervise banks and S&Ls would increase the long-run danger of systemic crisis by inhibiting the ability of depositories to adapt to changing conditions as they occur. We need greater supervision, but by the private sector.

Market value accounting is attractive in theory, and it should be used to the extent possible, but it should not be oversold. There simply are not "market values" for many bank assets—especially where smaller depositories are concerned.

I have addressed private deposit insurance.

Finally, brokered deposits are a symptom—not the disease. Imposing restrictions on deposit brokers would not deal with the underlying problems. Instead, depositors with accounts exceeding $100,000 would merely look for new ways to gain full Federal guarantees. Moving large accounts to those institutions designated as "too large to be allowed to fail" would suffice. Hence, imposing restrictions on brokered deposits could further weaken smaller institutions and serve to concentrate the industry unnecessarily.

Thank you for your time. I will be glad to respond to any questions.

[The prepared statement of Ms. England follows:]

Testimony presented before the
Subcommittee on Financial Institutions, Supervision,
Regulation and Insurance of the
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
September 19, 1985

Catherine England
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I would like to thank the committee for the opportunity to testify today.

I believe further deregulation of the nation's depository institutions is necessary primarily for safety and soundness reasons. History provides ample support for the conclusion that heavily regulated industries become increasingly inflexible and myopic. Their attention is directed from the market to the political arena as each industry participant attempts to persuade political decision-makers to protect his turf against short-term infringement by others. Members of protected industries almost invariably look to the government as the source of their long-term survival rather than to their own creativity and ability to serve the public.

The financial services industry has proved no different. Banking in the U.S. has been marked by crisis-driven legislation.[1] Political pressures frequently make it difficult for Congress to respond to changing conditions until the industry faced a life-threatening situation.

As technological conditions change more rapidly and world markets for financial services become increasingly interdependent. however, the nation's banks, savings and loans, credit unions, and other suppliers of financial services must become more flexible if they are to survive. This additional adaptability can come only by increasing the heterogeneity within the industry and forcing industry members to respond to competitive rather than political pressures. Market disciplines and rewards should play a greater future role in directing the nation's depository institutions.

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[1] I will use the term "banks" or "banking to refer to depository institutions generally.

Unfortunately, deregulation is incompatible with continued federal deposit guarantees as they are currently structured. There is an extensive economic literature arguing that a government guarantee of deposits undermines market discipline of depository institutions by making all insured deposits--whether held by a soundly run or poorly run institutions--essentially equivalent in value. A flat-rate deposit insurance premium compounds the problem by subsidizing the nation's riskier depositories. This subsidy is even more pronounced when a bank or S & L can undertake risk through an unregulated activity--especially through exploiting a loophole. The delays inherent in any regulatory or legislative reaction make it worthwhile for large depository institutions to expend vast resources discovering such loopholes. Finally, if the federal government, and hence the taxpayers, bear the ultimate responsibility for the security of deposits,[2] it would be foolhardy to suggest federal authorities should make no attempt to oversee the behavior of insured institutions.

Thus, deregulation is necessary to preserve the viability of the nation's depositories. But federal regulation and supervision are necessary as long as deposits are federally guaranteed. We must, therefore, find another way to protect small depositors.

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[2] While the deposit insurance funds are made up of funds collected from insured depositories, their lines of credit with the Treasury as well as the fact that they are backed by the "full faith and credit of the federal government" make taxpayers ultimately responsible for federal deposit guarantees.

Private Deposit Insurance[3]

A credible system of private deposit insurance would relieve small depositors of the need to monitor closely the behavior of their banks just as federal insurance does. But other market disciplines would arise instead. Depositors placing larger accounts should take an interest in the quality of private guarantees being offered, for example, as should depository institutions choosing an insurer.[4]

Furthermore, a private insurer's survival would depend on his ability to accurately assess and control the risk taken on by depository institution managers. Therefore, we should expect private guarantors to set high standards for the institutions they agree to insure, to insist on frequent financial reports designed to identify changes in an insured institution's condition, to insist on the ability to conduct on-sight examinations when necessary, to monitor changing national, regional, and local economic conditions in an effort to anticipate and offset cyclical problems, and to develop effective means of controlling the risk undertaken by a particular bank or S & L.

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[3] Private deposit insurance represents only one possible means of protecting depositors in a deregulated environment. Networks of banks similar to the "clearing house associations" could be formed to share technology, market new products, and provide liquidity during a cash short-fall. Or depositors at deregulated banks might insist their demand deposits be backed by marketable securities. There are a wide range of other possibilities. Further, an increased role for private guarantors opens the possibility of individuals' purchasing deposit insurance rather than institutions.

[4] This is one lesson available from the Ohio and Maryland insurance fund failures. Institutions choosing non-federal guarantees should now recognize their stake in promoting a strong insurance fund. It may not be enough that your institution is sound if your insurer cannot guarantee that others within the same system are sound as well.

Private deposit insurance companies probably would develop risk-related premiums. They might also insist on the right to pre-approve any major business decisions--fundamental changes in an institution's management, the range of products and services it could offer, or decisions to relocate or expand its operations. But rather than setting hard and fast rules, private guarantors would have the flexibility to deal with each bank's request to expand service on a case-by-case basis. The private insurer could consider the skill and experience of the managers, the general economic health of the institution and the region in which it operated, and whether the proposed expansion complemented other facets of the bank's operations.

Even a "no" need not be absolute where private insurance contracts are concerned. A privately insured depository might be allowed to attempt new ventures if it agreed to first increase its reserves, raise new capital, or issue subordinated debt, for example. Ultimately, it is in the best interest of private guarantors to promote individually sound, healthy institutions.

Furthermore, as new information became available, as economic or technological conditions changed, private guarantors could easily adapt their general standards and/or their monitoring techniques to reflect those changes. They would avoid the political review process. Further because a new regulatory strategy would not be applied nationwide when first introduced, private insurers could learn from one another's successes and mistakes.

Thus, the incentive of private insurers to protect themselves as well as the flexibility available to private contractors monitoring the behavior of insured depositories make private deposit guarantees a promising avenue for controlling the risk-taking behavior of banks while protecting depositors.

Tiered Deposit Insurance

Admittedly, some of my suggestions would not be met with public enthusiasm, especially in light of recent problems in Ohio and Maryland. Federal deposit insurance is widely accepted and, consequently, an understandable debate arises about what consumers value more highly--the flexibility and potential for new products and services brought about by deregulation or the short-term safety and stability offered by federal deposit insurance and the consequent federal controls. Having functioned under a heavily regulated system for 50 years, consumers and their bankers have an incomplete idea of what opportunities or pitfalls a less regulated market would offer. And the market for private guarantees remains in its infancy. Many questions remain, including significant uncertainty about how quickly answers can be developed and a viable private guarantee system develop.

But there is a means of avoiding these difficult issues while creating an environment in which alternative deposit guarantee systems can develop. A system of tiered deposit insurance, which I will describe, would allow bank customers to dictate the matters at issue. By deciding where to deposit their funds, consumers would determine the pace at which deregulation would proceed as well as the optimal extent of federal deposit insurance.

Suppose each bank could choose among several deposit insurance plans. At one extreme, a bank might be allowed to insure 100 percent of its deposits, extending explicit protection beyond that available today. In return, however, the bank would be subject to extensive government regulation: stringent capital requirements, high reserve requirements, strict controls over the range of its assets, restrictions on the types of liabilities it could offer, and restrictions on its ability to branch. At the other extreme, a bank would be allowed to choose to provide no federal insurance for its depositors. In that case, it would be subject to no federal regulation of its activities--no federally established capital requirements, no limits on the types of business in which it could engage or the range of products it could offer, no restrictions on its branching ability, and so on.[5]

Obviously such a plan should have intermediate options. These could take a number of forms. They could represent a specified percentage of each deposit, for example. Federal authorities could offer to insure 75 cents of each dollar deposited, 50 cents on the dollar, or 25 percent of each deposit. Alternatively, tiered deposit insurance could be patterned on the current system. Banks would be offered deposit guarantees that covered, say, the first $100,000 of every deposit, the first $50,000, or the first $10,000. There are a large number of possibilities.

As a bank chose to provide less federal insurance coverage for [illegible]s depositors, and the federal government's potential liability was consequently reduced, the bank would be subject to correspondingly fewer federal regulations. If current regulations were assigned to broad categories--branching restrictions, powers restrictions, capital requirements, and reserve requirements, for example--as a bank chose a lower "tier" of deposit insurance, it would be freed from an entire category of regulations. Other plans for removing regulations in an orderly manner could also be devised as long as the key provision of the plan was retained. As a depository accepted less government insurance, it would operate in a progressively less regulated environment.

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[5] For the sake of exposition, I am ignoring monetary control considerations as well as the role of the state governments in establishing branching guidelines.

Banks would, of course, be required to display information about the degree of federal insurance they offered and make sure their depositors understood how far their federal guarantees extended. Then banks offering the maximum federal insurance could cater to retirees or other customers concerned primarily with the security and immediate availability of their funds. Such customers would, naturally, accept relatively low interest on their deposits and would expect only the most basic banking services.

Other, less conservative consumers might opt for less federal insurance because geographic accessibility was more important to them, or because the convenience of one-stop financial shopping ranked high on their list of desirable bank characteristics. Indeed, any one consumer or family could place deposits in several institutions--a "nest egg" in an institution providing maximum federal coverage, a transactions account in a bank providing less coverage but a broader range of services or wider geographic access, and investment funds in a third establishment without federal insurance but offering higher returns and growth potential.

Bankers would face a tradeoff as well. They could have broader powers and greater freedom only if they were able to win the confidence of those depositors who subsequently sacrificed some or all of their federal deposit insurance. Bank managers who wished to pursue a less regulated route could no longer do so by assuming the federal government would be there to pay the bills should things go wrong.

Reassuring depositors might take the form of obtaining private guarantees, of increasing the bank's capital, of establishing that the new activities would diversify and, hence, stabilize, the bank's earning portfolio, or of some combination of these. Bankers unable to provide such assurances would lose depositors to more fully guaranteed, more heavily regulated institutions or to less regulated institutions that had satisfied the market of their stability.

When tiered federal deposit insurance was first introduced, most banks probably would choose to retain their federal guarantees. There would exist a great deal of uncertainty about how affected depositors would react to losing their federal insurance. But a few banks, with less risk-adverse depositors, whose depositors hold smaller accounts, or with adequate capital reserves would undoubtedly elect to accept less insurance in return for being allowed to exercise more freedom. If those banks proved able to attract and retain customers while turning less regulation (along with fewer federal guarantees) into an advantage, other banks eventually would follow. Meanwhile, the market would have time to develop mechanisms to protect depositors in a less regulated, less heavily insured financial market. On the other hand, if the public's concern with safety as provided by federal guarantees is such that consumers would favor strongly those banks retaining their FDIC coverage, the institutions that exercised broader powers would naturally be limited to a handful.

In addition to allowing consumers to choose the optimal degree of bank regulation and to choose the mix of regulated, federally insured depositories and unregulated, privately controlled banks, there are several other advantages to tiered deposit insurance.

Unlike the current regulatory system that favors the nation's largest institutions, able to afford lawyers and accountants talented in identifying and exploiting loopholes, tiered deposit insurance could actually give a competitive advantage to smaller banks and thrifts. Because smaller institutions generally have fewer large deposits, innovative small bank managers would be able to reduce their federal deposit insurance, continue to provide federal coverage for most of their depositors, and yet expand their operations by taking advantage of additional regulatory freedoms. Furthermore, during periods when regulatory restrictions proved dangerously constraining (as the Regulation Q ceilings did during the late 1970s and early 1980s), banks would have another avenue of relief while waiting for Congressional or regulatory action. Again, this could be particularly important to smaller institutions with fewer sources of regulatory avoidance readily available to them.

There is never a good time for substantive reform. When things are going well, there is little pressure to undertake dramatic change. When an obvious problem develops, significant change is delayed in the fear of putting additional stress on an already weak system.

Under a system of tiered deposit insurance, however, each bank could set its own schedule of deregulation, even choose to retain its federal insurance and comply with federal regulatory expectations indefinitely. During periods of relative calm, some institutions could choose to relinquish part or all of their federal insurance and step into a less regulated market without simultaneously dealing with a host of other crises. When prices or interest rates were fluctuating unpredictably or the country was suffering through a recession, however, further progress toward a deregulated industry could be delayed automatically until a more stable period returned.

Furthermore, if federal regulators face competition from the private sector, they will have both greater incentives and better tools with which to judge and price for risk. Indeed, if banks had a viable option, many of the objections to federally applied variable rate premiums would be undermined.[7]

In this regard, I find the experience of credit unions over the past 10 years particularly enlightening. The credit union industry, as a whole, has adapted to, even profited from, recent economic and regulatory upheavals more successfully than either the banking or thrift industries. While there are obviously many important differences between credit unions and other depositories, I would credit a large part of their success to the fact that they enjoy a truly dual chartering and insurance system. Private guarantors and state regulators have shown themselves capable of adapting successfully to rapidly changing conditions. With responsibility for fewer credit unions and an ability to monitor closely the subsequent results, private insurers and state authorities have led the way in allowing experimentation and innovation among credit unions. This flexibility at the state level has almost certainly increased the flexibility and willingness to innovate here in Washington.

I am convinced that the heterogeneity enjoyed by the credit union industry represents an important strength and a potential competitive advantage in the long run. I see tiered deposit insurance as a mechanism for introducing the same sort of heterogeneity and flexibility into the banking and thrift industries.

Finally, and most important, this system would reduce the probability of system-wide failure. The savings and loan industry provides a striking example of the risks associated with an error in regulatory judgement. The entire industry, with the possible exception of those associations formed since the late 1970s, has been seriously weakened by the earlier emphasis on low-cost, long-term, fixed rate mortgages funded by short-term liabilities.

No one could have foreseen the economic and technological upheavals that occurred during the 1970s and early 1980s. Similarly, no one can predict from where the next financial crisis will come. Consequently, any regulatory system that makes decisions for all depository institutions places all institutions at risk if events unfold in an adverse manner.

A tiered system of deposit insurance, on the other hand, would have the advantage of creating wider diversity among the nation's financial institutions. Some banks would operate under government imposed restrictions. Others would, by choice, function in a less regulated environment. And even among the institutions insured by private funds, there undoubtedly would be differences in the powers banks exercised.

If loans to a particular industry or group of countries turned sour, then, some institutions would be at risk, but not all. If investments in life insurance companies took a turn for the worst, a handful of banks could face problems, but others would stand ready to receive deposits on the basis of their strengths. If a regulatory decisions restricting branching proved unduly limiting, a few depositories would suffer, but others would avoid the crisis. The more heterogeneous the banking system is allowed to become, the more we reduce the opportunities for systemic crises. Runs are more likely to occur when depositors view all banks as being fundamentally the same and, as a result, subject to the same weaknesses. To the extent consumers come to look on depositories as a diverse set of institutions, exercising widely varied powers, problems at one bank are more likely to be viewed as unique to that institution and the danger of system wide failures is further reduced.

Proposed Deposit Insurance Reforms

Finally, in accordance with the subcommittee's request, I will comment briefly on the twelve proposed reforms:

1. Modified payoffs. Any change that introduces more market discipline into the system will ultimately strengthen our financial institutions. Modified payoffs are a step in that direction, and if they are imposed without regard to the size of the failed institution, modified payoffs would encourage depositors to monitor more closely the behavior of their depository. I am concerned, however, that depositories of different sizes would be treated unequally, with decisions based on the size of the institution involved. This would make it more difficult for smaller institutions to attract and hold customers with large accounts, providing a government-sponsored boost toward concentration of the industry.

2. Subordinated debt capital. Banks and other depository institutions should be allowed to count some subordinated debt toward their capital requirements. To protect their investment, subordinated debt holders would have an incentive to monitor the behavior of financial institutions, and they would be unable to run if trouble developed. Thus, through pricing subordinated debt, the market could reveal useful information about the relative risk of various depositories.

I do not favor a uniform requirement applied to all institutions, however. Such a requirement would send all financial institutions into the debt market at the same time, placing them at a disadvantage relative to potential investors. Further, it may be difficult, and totally unnecessary, for banks and S & Ls in rural areas to place subordinated debt. Finally, any uniform requirement must, of necessity, leave some banks undercapitalized and others overcapitalized.

3. and 4. Risk-related deposit insurance premiums and risk-related capital requirements. When determined through a market process, risk-related premiums and capital requirements can be an important tool in controlling the risk undertaken by managers of depository institutions. But they carry serious disadvantages if administered by a federally-sponsored, monopoly supplier of deposit guarantees.

It is widely accepted that any federally administered system of variable premiums would have to be based solely on objective criteria. While ratios and trend analyses can provide important clues to the risk associated with a particular institution, however, they cannot incorporate equally important subjective information--the ability and experience of the bank's management, the economic health of the local community, etc.

Further, as soon as a formula for assigning risk was announced, bank managers would set their accountants and economists to determining how they could undertake risks that would not be fully reflected by the formula. Changing technological and economic conditions would also contribute to the process of obsolescence. But revising the formula necessarily will have political ramifications, however, making continuous fine-tuning of the system difficult.

Furthermore, special interest groups could be expected to attempt to use federally administered risk-related premiums to promote social goals. What federal regulator, for example, would have had the courage to (or would have been allowed to) penalize the savings and loans for concentrating their loan portfolios in geographically undiversified home mortgages, and for mismatching their assets and liabilities to the extent they did?

In addition, a government sponsored formula would be based on historical evidence, designed to reflect past realities as those risks are at least documentable. Consequently, federal insurers would attempt to raise premiums after an institution encountered difficulties, thus serving to exacerbate the problem rather than prevent it.

Finally, without market feedback, there is no mechanism through which to discover whether the federal authorities are accurately assessing the risk being undertaken by banks. Nor is there a means for determining the "correct" amount of risk banks should be allowed to take on in their role as financial intermediaries.

5. Insurance fund recapitalization. While the funding problems of the FSLIC represent an important concern, providing further funding without addressing the underlying problems would only delay the reckoning that must eventually come. In addition, asking the savings and loan industry to help recapitalize their insurance fund places additional strain on an already troubled sector.

6. Insurance fund merger. As with insurance fund recapitalization, a merger of the FDIC and the FSLIC may address the immediate concern, but (even more than recapitalization) it masks the more serious underlying problems that will cause recurring crises unless resolved.

7. 100 percent deposit insurance coverage. 100 percent coverage would reduce further the market incentives to monitor the industry, arguably requiring even more extensive oversight. But increased federal oversight would lead to its own problems.

8. Reduced deposit insurance coverage. Because I believe increased market discipline is our best hope for a structurally sound financial services industry, I support making available the option of reduced deposit insurance

coverage. But fewer federal guarantees should be accompanied by reduced federal regulation.

9. Greatly intensified supervision. A federal commitment to more closely supervise banks and S & Ls would of necessity force these institutions into particular molds and limit their flexibility. Consequently, it would increase the danger of systemic crisis by inhibiting the ability of depositories to adapt to changing conditions as they occur. We need greater supervision, but by the private sector

10. Market value accounting. Market value accounting is attractive in theory, and it should be used to the extent possible. But it should not be oversold. There simply are no "market values" for many bank assets--especially where smaller depositories are concerned.

11. Private deposit insurance. I have addressed this in my earlier remarks.

12. Brokered deposit restrictions. Brokered deposits are a symptom--not the disease. Imposing restrictions on deposit brokers would not deal with the underlying problems. Instead it would challenge the market to develop a new way for depositors with accounts in excess of $100,000 to gain full federal guarantees. Moving large accounts to those institutions designated as "too large to be allowed to fail" would suffice. Hence, imposing restrictions on brokered deposits could further weaken smaller institutions and concentrate the industry unnecessarily.

Thank you for your time. I will be glad to respond to any questions.

Chairman **St Germain**. Now, we will hear from Mr. Kareken. We will put your entire statement in the record. You may proceed.

STATEMENT OF JOHN H. KAREKEN, PROFESSOR OF BANKING, UNIVERSITY OF MINNESOTA

Mr. **Kareken**. Thank you. I appreciate the opportunity to testify here this morning. I, too, believe that there is an urgent need for deposit insurance reform. Unless the Congress changes the way in which depositors' claims on depository institutions are protected, financial instability has to increase steadily.

Moreover, there can be no thought of pressing ahead with deregulation until reform—more precisely, sensible reform—has been effected.

There is one caveat called for. Restrictions on where depository institutions may locate are exceptional. They can, and as I believe, should be eliminated even if the Congress does not change the way in which deposits are protected.

But other restrictions can't be eliminated. It suffices to note that Congress, partly on the advice of the regulatory agencies, made a very serious mistake in eliminating deposit insurance rate ceilings before reforming the deposit insurance scheme.

As was noted just a moment ago, the way in which deposits are and have long been protected invites risk-taking. That is fundamental. It is also fundamental that the possibility of the failure of a depository institution ruining the careers of the failed institutions' most senior managers does not appear to limit risk-taking sufficiently.

Nor does supervision by our regulatory agencies. Recent history makes that all too apparent. Putting more resources into supervision could help, I believe, and perhaps the Congress ought to consider using public accountants, those who audit our depository institutions as, in effect, regulatory agencies' examiners.

In Germany, for example, public accountants audit banks not only for shareholders, but also for Federal bank supervisory authority; and recently the English regulatory authority, the Bank of England, proposed that public accountants serve as well as——

Chairman **St Germain**. Mr. Kareken, I am sorry, but you know, who would hire these—who would decide which public accountants were going to audit?

Do you get to that in your paper?

Mr. **Kareken**. No.

Chairman **St Germain**. Frankly, our experience to date has been that they are not the purists many people thought they were. They are very human and they can be swayed by circumstances.

Proceed.

Mr. **Kareken**. I did say I thought it was something you ought to consider. I haven't studied the possibility carefully enough. I have just returned from England and Germany, and I got some exposure to it, but in Germany, for example, the stockholders' choice of an auditor is subject to the approval of the supervisory authority and moreover, the supervisory authority advises public accountants on how audits are to be done.

I am not advocating use of public accountants at this point, but there is a real problem of the resources required for adequate bank examination or, more generally, supervision, and one way to get access to those resources is by making public accountants serve two masters.

I also believe, though—and this may come to the point just made—that the supervisory process is inherently flawed.

Whatever the amount of resources used, supervision of depository institutions will not sufficiently limit the risk-taking induced by the way in which currently our deposits are protected. The implication is that there has got to be deposit insurance reform.

For the Congress, it obviously isn't good enough to be told that we need reform. For the Congress, the question is how to reform. Undeniably, it is, I think, awkwardly placed, for it is confronted with bewilderingly many possible ways of reforming the present-day scheme.

We were given 12 ways to reform the system, and asked to comment on them. For the most part, I am going to leave my comments, if anyone is interested, to the question period and content myself for the moment with rather a sweeping claim, namely, that of all the 12 different ways offered for us to consider, there isn't one that is both sensible and practicable or feasible, and is also in its effects far-reaching enough to reduce the threat of financial instability.

By way of illustration, a subordinated debt requirement is sensible, and of course practicable, but no one should expect that to make any depository institution have even short-term subordinated debt in the amount of 3 or even 4 or 5 percent of its assets will result in a significant policing by private lenders.

In contrast to the subordinated debt requirement, risk-related deposit premiums is, pure and simple, not now practicable. I emphasize now, for I do believe that in principle, risk-related premiums is the way to go. Indeed, with the proper scheduling of premiums, no regulation of depository institutions would be necessary. At this moment, however, we are without an adequate theory of risk-related premiums, and if we had an adequate theory, there would still be the unsolved practical problem of how to identify the balance sheet strategies of depository institutions, those strategies being what should determine the insurance premiums paid by depository institutions.

With my time running out, I turn now to what in my judgment the Congress has to do, and that is, whether literally or in effect, to force a split of banking into two separate industries, one supplying only payment services and having insured demand deposits balance or in the modern idiom transaction accountables; and the second industry, entirely unregulated, supplying all the other traditional banking services, and more, but having no insured liabilities.

Under the arrangement I have in mind, transactions account balances would be insured not by an agency of the Federal Government, but because depository institutions supplying payment services and, hence, having transactions account balances would be required to back those balances 100 percent with short-dated Treasury securities, valued at market prices.

And because those institutions supplying deposit services would be limited, whether by statute or regulation, to having only transaction account balances. Technological progress has made it possible for depository institutions to, as it were, hide transaction account balances and to have those balances insured, the institutions supplying payment services would have to be prevented from hiding them. The only way of doing that is to limit them to such balances.

Underlying the arrangement, I propose there is one assumption that may be controversial. That is, with regard to depository institutions, the Government's responsibility ends with protecting against widespread disruption of the payments process or to translate, with protecting against bank runs.

But there is no good reason why the Government should be, as at present, protecting owners of time and savings deposits. For one thing, there are safe assets available, namely, Treasury securities, and if they are not now issued in convenient denominations, they easily could be.

Moreover, if I am right in insisting that the Government's responsibility should be more narrowly defined than at present, then there is no reason to regulate depository institutions as suppliers of other than payments services.

What I have proposed—again, a split of banking as traditionally defined into two industries—may seem somewhat radical. Perhaps that is right. I would, however, note that our present-day problem is the result of a more or less accidental historical evolution.

There simply is no good economic reason why the profession of payment services and lending, which is inherently risky, have to be combined in a single set of institutions. I would also note that a while back, in what has come to be referred to as his Grandma Jones' speech, the chairman of this subcommittee also recommended, if for a rather different reason, that banking be split about as I have suggested.

Thank you.

[The prepared statement of Mr. Kareken follows:]

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It is, of course, an honor having been asked to testify here this morning before the Financial Institutions Subcommittee of the House Banking Committee. I have prepared a very brief statement and, with the chairman's permission, will simply read it.

I believe that there is an urgent need for deposit insurance reform. Unless the Congress changes the way in which depositors' claims on depository institutions are protected, financial instability will steadily increase. Moreover, there can be no thought of pressing ahead with deregulation of depository institutions until reform -- or, more precisely, sensible reform -- has been affected.

I must here insert a caveat. Restrictions on where depository institutions may locate are exceptional; they can (and, as I believe, should) be eliminated even if the Congress does not change the way in which depositors are protected. But, again, other restrictions cannot be eliminated. It suffices to recall the serious mistake that the Congress made, partly on the advice of the regulatory agencies, in eliminating deposit interest rate ceilings before reforming our deposit insurance scheme.

The way in which depositors are (and have long been) protected invites risk-taking by depository institutions. That is fundamental. It is also fundamental that, to all appearances, the possibility of the failure of a depository institution ruining the careers of the failed institution's most senior manages does not limit risk-taking sufficiently. Nor does supervision or, more particularly, examination by our regulatory agencies. Recent history makes that all too evident.

Putting more resources into supervision could help, and perhaps the Congress ought to consider using public accountants, those who audit depository institutions, as in effect regulatory agency examiners. In Germany, for example, the reality is public accountants audit banks not only for share holders but also for the Federal Bank Supervisory Authority, and recently the english regulatory authority, the Bank of England, proposed that public accountants serve it as well as their bank clients.

It seems to me, however, that human nature being what it is, the supervisory (or examination) process is inherently flawed. In other words, whatever the amount of resources used, supervision of depository institutions will not limit sufficiently the risk-taking induced by the way in which, at present, we protect depositors. The implication is that there must be deposit insurance reform.

For the Congress, it is obviously not good enough to be told that our deposit insurance scheme must be reformed. For it, the question is how. And, undeniably, it is awkwardly placed, for it is confronted with what must be bewilderingly many possible ways. To illustrate, we who are here this morning to testify were asked to comment on no less than 12 different ways. There is no way I can do that in the 10 minutes allotted me. For the most part, I must leave my comments on those 12 different ways until the question period and, for now, content myself with what may seem too sweeping a claim: namely, that of all the 12 that the subcommittee staff asked us to comment on, there is not one that is both sensible and practicable or feasible and as also, in its effects, far-reaching enough to reduce sufficiently the threat of financial instability that is inherent in the present-day deposit insurance scheme.

Thus, imposing a subordinated debt requirement on depository institutions is sensible and, of course, practicable. But no one should expect that making a depository institution have (even short-term) subordinated debt equal to 3% -- or 4% or 5% -- of its assets will result in sufficient policing by private lenders.

In contrast to the subordinated debt requirement, risk-related insurance premiums is, pure and simple, not now practicable. And I emphasize "now," for in principle we should have risk-related premiums. Indeed, with the proper premium schedule, no regulation of depository institutions would be necessary. At this moment, however, we are without an adequate theory of risk-related premiums; and if we had an adequate theory, there would still be the unsolved practical problem of how to identify the balance sheet strategies of depository institutions, those strategies being what should determine the insurance premiums that are paid.

With my time running out, I turn now, though, to what in my judgment the Congress should do: whether literally or in effect, force a split of banking into two industries, one supplying only payments services and having insured demand deposit or, in the modern idiom, transactions account balances; and a second industry, entirely unregulated, supplying all the other traditional banking services and more, but having no insured liabilities.

Under the arrangement I have in mind, transactions account balances would be insured not by an agency of the federal government, but because depository institutions supplying payments services and, hence, having transactions account balances would be required to back those balances 100% with (short-dated) Treasury securities valued at market prices, and because they would be limited, whether by statute or regulation, to having only transactions account balances. Technological progress has made it possible for depository institutions to, as it were, hide transactions account balances. And to have insured transactions account balances, those institutions supplying payments services would have to be prevented from doing that.

Underlying the arrangement I have proposed, there is one assumption that may be controversial: that with regard to depository institutions, the government's responsibility ends with protecting against widespread disruption of the payments process or, to translate, with protecting against bank runs. But there is no good reason why the government should be, as at present, protecting owners of time and savings deposits. For one thing, there are safe assets available, Treasury securities; and if they are not now issued in convenient denominations, they easily could be.

Moreover, if I am right in insisting that the government's responsibility should be more narrowly defined than it has been, then there is no good reason to regulate depository institutions as suppliers of other than payments services.

What I have proposed -- again, a split of banking, as traditionally defined, into two industries -- may seem radical. Perhaps that is right. I would, however, note that our present-day problem is the result of a more or less accidental historical evolution encouraged, at least in the United States, by government regulation. There is no good economic reason why provision of payments services and lending, which is inherently risky, should be combined in depository institutions.

Thank you.

Chairman **St Germain**. Thank you, Professor Kareken.

Forgive me for not addressing you properly, Professor. Professor Kareken is a professor of banking at the University of Minnesota. Did you have a sabbatical in Germany this year?

Mr. **Kareken**. No; it was all of a 2-week trip.

Chairman **St Germain**. You learned a lot in 2 weeks.

[The following paper by John H. Kareken was subsequently received for inclusion in the record:]

ENSURING FINANCIAL STABILITY

SUMMARY

In this paper, I first consider whether the U.S. federal government (for short, government) ought to be occupied in trying to maintain financial stability.[1] Or, what by my definition is equivalent, in trying to maintain sound commercial banks or, more generally, depository institutions. To begin, I argue that there is only one reasonably persuasive justification for the government—writ large, to include the Federal Reserve System—being so occupied. Because banks or, now, depository institutions do most of the settling up, a bank run is an especially serious economic disruption. And thus, if a run would be a real threat under the *laissez faire* banking policy, the government must try, somehow or other, to protect against there ever being another run.

But, in the first part of my paper I also argue that under the *laissez faire* banking policy there would be no chance of a bank run. Nor does history contradict me, for from the beginning U.S. governments have been engaged in trying to protect owners of bank deposits. To me, that is a most suggestive fact, if fact it be: I take seriously that government attempts to protect owners of bank deposits are what explain those bank runs that have made U.S. financial history so chaotic.

There is some evidence that economic units have all along wanted safe transactions account balances. But if that is right, then there is an obvious question to be answered. Competition delivers autos in the popular colors. So why has it never delivered such balances? My answer, elaborated in the first part of the paper, is that because owners of transactions account and other bank balances have, generation after generation, mistakenly relied on governments for protection, there has been nothing for competition to deliver. It would seem to follow that under the *laissez faire* banking policy the U.S. banking industry would not be inherently unstable: more particularly, there would be no fractional reserve banking.

There is, however, a second part to my paper, in which, because confidence is not my forte, I consider how government can best make transactions account balances safe. And in the second part I argue that having the federal government insure those balances is not the best way. As it seems to me, we are a long way from being able to introduce risk-dependent insurance premiums. Those who believe otherwise do not take seriously enough the difficulty in identifying bank balance sheet strategies from extremely small samples of observed outcomes. Moreover, history shows that regulation and supervision (which, with risk-dependent premiums, are necessary when bank balances are insured) cannot be relied on to keep banks safe.

The federal government would, I believe, be well-advised to stop insuring bank balances or, in other words, simply close down the FDIC (and, of course, FSLIC). If it is to serve protector, it should require that all transactions account balances be backed 100 percent with interest-bearing Treasury securities and, further, that any company having transactions account balances have no other balances. Technological change makes that second restriction necesssary; it has come to cost too little to make a transactions account balance disappear when needed reappear.

INTRODUCTION

In the realm of argument, a Supreme Court Justice can get away with just about anything. Or is it that a justice of our highest court does not argue, but rather only pronounces? No matter. We cannot deal with financial stability as Justice Stewart dealt with pornography. We must know what each of us by that key phrase "financial stability," and unfortunately there are several possible definitions, all more or less reasonable. But the organizers of this conference have told us which one to use; and glad I am that they have for I came to this manner with no clear sense of how financial stability to be defined. In paraphrase, their definition goes as follows: financial stability obtains when depository institutions, those involved in supplying monetary assets, are sound.

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[1] Prepared for the Federal Reserve Bank of San Francisco Conference "The Search for Financial Stability: The Past 50 Years," Asilomar Confernce Center, Pacific Grove, CA, June 23-25, 1985.

That definition is not entirely satisfactory. But, then, at a guess, it was not meant to be. By design, it is laden with ambiguities. To illustrate, what are "monetary assets?" And what does "sound" mean? No doubt, the intent was that we should answer those questions for ourselves.

For all its ambiguities, the definition provided us is, however, extremely useful. I found it so. It can be turned into a question, albeit one no less filled with ambiguities than the definition. Is the soundness of U.S. depository institutions, those involved, that is, in supplying monetary assets, a legitimate responsibility of the U.S. federal government (to which hereafter I almost always refer simply as the government)? For me, that is the question, and in the first part of this paper I attempt an answer.

Someone else may know when that question was first asked. I do not, although I am quite sure it was a long time ago. Over a long stretch of years, no one has answered it to the complete satisfaction of many others, and I am also quite sure that, come the end of this paper, I will not have. But I will be more satisfied if I am judged to have been not irresponsible, but provocative.

I did not phrase my question as generally as I might have. Instead, guided by the instinct for survival, I substituted "U.S. depository institutions" for "depository institutions." I know little about U.S. depository institutions and even less about the depository institutions of other countries. Moreover, in considering the question of whether the government has a responsibility for (in the sense of this conference) financial stability. I limit myself to banks, by which I mean commercial banks doing business in the United States and to which on occasion I refer as our or the banks. There is, however, nothing lost in my doing that. If maintaining the soundness of banks is a worthy endeavor of the government, there is a reason why. So it is only required, once the reason has been adduced, to determine which, if any, of our other depository institutions are, in the relevant ways, sufficiently like our banks.

In the first part of this paper, then, I consider whether the government ought to be concerned about the soundness of banks. There I argue that it is in the public interest for the government to guard, as best it can, against bank runs. I also argue, though, that but for the attempts by U.S. governments to guarantee owners of deposit balances against loss—early on attempts by state governments and, nearer to the present, by the federal government—the U.S. banking industry would under the *laissez faire* banking policy be inherently stable. Or, to work in that classic phrase—due, I believe, more to Henry Simons than anyone else—it would not be inherently unstable.

I do not say that if the government were all of a sudden to adopt the *laissez faire* policy, it would find the banking industry inherently stable. It might not, for our banks have long been operating under policies all very different from the *laissez faire* policy. To put the point another way, inherent stability might be achieved only after a period of adjustment, a period which, however, could be quite brief.

I do not in this paper get into how the transition to the *laissez faire* banking policy might be managed. That is mostly because, despite how I argue in the first part of this paper, I do not end that part—or, if I did, what would be the only part—with a plea for adoption of the *laissez faire* policy. This paper does have a second part, in which I consider a second question: What is the best way of trying to ensure that the United States never again experiences a bank run?

I go on to that second question for the best of reasons. There is no way of establishing beyond all doubt that, but for attempts by U.S. governments to make deposit balances safe, the U.S. banking industry would long ago have become inherently stable or, as might be said, run-proof. On occasion, in the dark of night, I whisper to myself that I could be very wrong. And naturally I am interested in what I should have to endorse to protect against that awful possibility of being very or, indeed, tragically wrong.

In the second part of the paper I argue that insuring owners of deposit balances is not the way to make the banking industry run-proof. Obviously, fully insuring all bank creditors is a way of eliminating any threat of a run. It is only required that the government's promise of no losses be believed. As is well known, though, unless insurance provided by the government is properly priced, there is a misallocation of real resources. And my point, elaborated in the second part of the paper, is that we still do not know, except in a very general and therefore unhelpful way, how federal deposit insurance should be priced. Thus, I do not end up in this paper by advocating the introduction of risk-dependent insurance premiums. Rather I advocate, first, doing away with government deposit insurance, that provided by the FDIC (and, if S&Ls are considered to be banks, by the FSLIC) and that provided by the Federal Reserve, and, second, whether actually or only in effect, splitting banks into payments services and lending businesses and requiring those engaged in providing payments services to hold 100 percent reserves of Treasury securities against their only liabilities transactions balances.

WHY A GOVERNMENT COMMITMENT TO SOUNDNESS?

Among all of the reasons that have been given for why the government should be committed to keeping banks sound, the desirability of protecting the deposit balances of the financially naive and poorly off gets pride of place. To quote a state legislator of long ago:

> The loss by insolvency of banks generally falls upon the farmer, the mechanic, and the laborer, who are least acquainted with the conditions of banks and who, of all others, are most illy able to either guard against or sustain loss by failure.

That justification [see Kareken 1983] dates from 1829, more than a 150 years ago. Even today, though, pallid paraphrases are still being offered. Why should present-day banks be sound? Not every U.S. resident of the present is financially sophisticated and well off; and those who are both financially naive and of modest or even less than modest means (in my shorthand, the naive poor) are deserving of having their deposit balances protected, as deserving as were their brothers and sisters of 1829.

If "sound banks" does not seem quit follow, there is an important part of the argument emphasizing the naive poor that I have not yet given: the claim that, independent of walk of life, a bank balance subject to third-party transfer is an abolute necessity; or that if the financially sophisticated and well off cannot get along without transactions account balances, neither can the naive poor.

Note, thought, that at best all we have is an argument for safe transactions account balances.[2] For one thing, there has long existed an almost perfect substitute for a safe savings account balance: namely, a savings bond. What also has to be kept firmly in mind, Treasury bills could be made available on demand in, say dollar units. It might be argued that even if warned, the financially naive would go right on holding (uninsured), savings account balances. Perhaps, but to me the claim that an educational effort would help little, if at all, is not persuasive enough to get us from "social justice" to safe savings account balances. Using the claim to justify the government being responsible for safety of all bank balances, savings account as well as transactions account balances, is at least faintly ridiculous.

That there are relatively as many naive poor now as there were in 1829 or, indeed, 1933 is, I believe, doubtful. But even if there were more, a desire to protect them would not justify the present-day $100,000 statutory maximum for government deposit insurance. A statutory maximum on the order of $1,000 could easily be excessive.

There is another point of some relevance. As a result of the elimination of restrictions on rates paid to depositors by banks, check-writing has for some (mainly the poor) apparently become more expensive than it was. Consumerists have lately been making much of that. And they have found an ally in Congressman St Germain [see St Germain 1984]. If, however, the push for life-line banking comes to naught, then there will likely be many fewer check writers among the naive poor than there were. So much for the notion that, independent of cost, having a transactions account balance is a necessity. All of the foregoing is by way of saying that those who want safe transactions account balances for the naive poor may be concerned about what is or soon will be a tiny proportion of the population. Of course, for an argument of the heart, the number involved may be thought unimportant. But, again, as I observed above, protecting the naive poor could be managed with a statutory government deposit insurance maximum of way less than the current $100,000.

No Undue Concentration

When the FDIC was created, protecting the (naive) poor was but one of the objectives; another was to prevent a radical transformation of the banking industry, a transformation that in 1933 was some way along. Back then, it was widely believed, even in the 73rd Congress, that a government guarantee of bank balances was necessary for the survival of thousands of small banks. For some members of that Congress, there was a real threat of a handful of banking behemoths coming to dominate the economy and perhaps political life as well. In the present, that threat may seem far-fetched. Yet, there is the possibility of a government commitment to bank soundness being essential for the maintenance of a socially desirable banking industry structure.

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[2] I say "at best" only because, although how is quite beyond me, there may nevertheless be a practical way of making just the transactions account balances of the naive poor safe.

I do not myself take that possibility seriously. There is no evidence that a close approximation of the structure of, for example, the English banking industry would be the *laissez faire* outcome for the United States. As it appears to me, the present-day English structure (and here too I think of "banking" in its narrow sense) is in no small part the result of government policy. From before the turn of the century until late in the 1960s, the English clearing banks lived together as a price-fixing oligopoly. Early on, they did so with the government's approval; and from sometime in the 1930s, they did so at the government's insistence. We know, though, that competition is not easily suppressed and that, much more often than not, price-fixing breeds nonprice or quality competition. Thus do I account not only for England coming so quickly to be a awash in bank branches, but also for its having so few banks.

If there is an exceptional banking industry structure, it is that of the U.S. banking industry. That, however, gives me but little pause. It has long been widely believed that there is more safety in a few than in many, or that an industry made up of a few large banks is more stable than one made up of many small banks. That may be right or, perhaps somewhat less likely, wrong. But I do not have to bother with which it is, for what is widely believed can, even if quite wrong, have an effect. And I see the interesting possibility of governments other than the British also wanting stable banking industries, all contriving to produce extraordinary concentration.

A couple of decades ago it might have been argued that just the enormity of the United States made an English-style banking industry very unlikely. And because, among other things, population density matters, Canada was not as good a counterexample as a naive comparison of square miles might seem to suggest. For banking, technological advance has, however, made physical distance ever so much less than it was, and I am therefore a little doubtful that the vastness of the United States is the effective barrier it once was to a banking industry that would be by any historical standard very highly concentrated.

And, yet, if we are part way through what can only be described as a technological revolution, there is nothing, neither theoretical arguments nor empirical evidence, to suggest that economies of scale have become more pronounced in banking. Or that economies of scope have. For banking, the best approximation would still seem to be that, except where output is small, virtually every service is produced at a constant average cost that is, by and large, independent of the quantities of whatever other services are being produced.

A Federal Reserve Argument

Had my assignment been to come up with a convincing rationale for the soundness of banks being a legitimate responsibility of the government, I would be doing badly. I have dismissed the argument that a government guarantee of soundness is necessary for the preservation of a socially desirable banking industry structure; and I have suggested that the consumerist argument, a modern variation on a hoary theme, may justify some sort of arrangement for protecting the transactions account balances of a relative few, but not the commitment under which the government currently labors.

There is, however, a third argument to be considered, one much favored by the Federal Reserve: that for various reasons banks are special; or that how they fare is of special concern, of greater concern, that is, than how, for instance, widget manufacturers fare; and, more particularly, because banks are special, it is right and proper that they be more tightly regulated than, among other companies, the manufacturers of widgets.

Below, I also argue, if with much less confidence than the Federal Reserve, that banks are special. Our explanations, mine and the Federal Reserve's are, however, rather different. Naturally, I fancy that mine is quite satisfactory and that its is not.

The Federal Reserve has often observed [see Volcker 1983] that banks are—or, with DIDMCA, the Depository Institutions Deregulation and Monetary Control Act, and the Garn-St Germain Act having been added to our statute books, are among—the economic units through which it works its monetary policy magic. And in the current scheme of things that is right. We have only to note that virtually every bank is, by government decree, obliged to in effect hold some currency (or satisfy a reserve requirement).

Another of the Federal Reserve's oft-made observations [see, for example, FRBM 1982] is that banks are the ultimate source of liquidity for the economy. And in a way that too is right. For some decades now, banks have had access to the discount windows of their Reserve Banks. So, when it wants, the Federal Reserve can lend through them—as it did when, quite some years ago, Penn Central failed. And they, our banks, may therefore appear as the ultimate source of liquidity.

What we come down to then, is that, according to the Federal Reserve, banks occupy a special niche in the present-day scheme of things. But, clearly, if banks are special for the reasons that the Federal Reserve has given, they are special because they have been made so. And in a different scheme they might well not be special.

If official open market operations are to have real effects, then, depending on circumstances [see Wallace 1983], it may be necessary for the government to force some economic units to hold currency. Whatever circumstances are, though, it is not required that banks be the chosen economic units. The point has been nicely made by Fama [1980]. Then, too, it is easy to imagine the Federal Reserve serving as lender of last resort, yet not making its emergency loans through banks.

Thus, in its analysis the Federal Reserve implicitly assumes that of all possible schemes of things, the present-day scheme is best. That, however, cannot simply be assumed or asserted. It has to be argued. And so far the Federal Reserve has not favored us with an argument. Seemingly, the Federal Reserve is guilty of having been, for the first time in its long history, just a little bit superficial.

But Banks Are Special

Are banks special? Not that the Federal Reserve is alone in having asked, but it was in attempting to answer that question that it came to highlight banks as the economic units through which it works its monetary policy magic and, in times of stress, makes its emergency loans. So it might better have asked a slightly different question: Is there something basic to banking that makes banks special?

I must of course grant that "basic" is ambiguous. What is basic to one person may not appear so to the next. In my version of the question, though, there is a warning of sorts: that we should not be distracted by what banks happen to do in any particular scheme of things or under a particular monetary regime. Unless, that is, the particular regime happens to be a close approximation to the *laissez faire* regime.[3] Recall what is to be avoided: regarding banks as special just because they happen to be so under the more or less accidental monetary regime of the moment.

For me, however, there is something basic to banking that makes banks special. That is because of how I use "bank." By my definition, a company is a bank only if it is engaged in the business of making payments for customers or, alternatively, of making sure that every customer's payments are in fact made per his or her instructions. It follows [again, see Fama 1980] that those who are young enough may one day live in a world without banks. Imagine a payments technology involving (1) debit cards, smart or dumb, (2) amazingly many on-line POS terminals, some portable, (3) a computer network with memory sufficient for the balance sheets of all economic units, and (4) for each economic unit, a rule which indicates, conditional on the new entry actually recorded, how its balance sheet is to be adjusted. We may never adopt that or an essentially similar technology. But the prospect of banks disappearing should not be troubling. After all, there presumably was a time when every economic unit made all of its own payments. More generally, there is nothing wrong in associating a particular public policy problem, real or imagined, with a specific technology, or in using a definition which implies, among other things, that what is thought to be a problem will vanish with sufficient technological change.

It must be obvious where I am headed. I should very much like to be able to insist that there is exceptionally great economic loss when, for whatever reason, payments cannot be made in what has become the customary way. I cannot, being unable to point to even one model that is sufficiently rigorous and yields my claim as an implication. All I can do is offer a conjecture and hope that it is intuitively as plausible to others as it is to me. If it is not, then I am in some difficulty, for what follows rests on the conjecture being right.

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[3] Think of the *laissez faire* monetary regime as the commodity money regime under which the government does nothing to influence the supply of the commodity, perhaps gold, being used as the means of payment. Then, as a close approximation, we have the fiat money regime under which the government, as monopoly supplier, simply goes on increasing the outstanding stock of currency at a constant rate and, besides making desired denominations available, does nothing else

Any sudden or surprising disruption in the economy is bound to be costly. That is why, for banks to be special, the cost of a sudden (and widespread) disruption of the payments process must be exceptionally great. And if there is a good explanation for an exceptionally great cost, it is that settling up is an all-pervasive activity.

I go back to my manufacturers of widgets. There may be no close substitutes for the widget, neither in production nor in consumption; or if there are, quickly expanding production of one or another of them may be impossible or, more reasonably, extremely costly. It is difficult to accept, though, even assuming no close substitutes and, for whatever substitutes there are, steeply increasing marginal cost curves, that the surprise disappearance of widgets would produce an economic loss approaching that attributable to (an appreciable proportion of) economic units suddenly being unable to settle up as they had been. If payments cannot be made in the customary way, then, until a change in method has been affected, economic activity must pretty much cease. Producing for inventory is not something to be done for very long; nor, unless there has been a change in rules, can buying on promise go on for very long.

Sheepishly, I apologize for having been so vague. It is just that, however much I may long to be more precise, I am at the moment unable to be more so.

Not Each and Every Bank

I have conjectured that a widespread disruption of the payments process is especially costly. And now I add a second conjecture: that a bank run, one which results in a sufficiently large number of banks going under, will greatly disrupt the payments process or make settling in the usual way impossible. That strikes me as easy to accept; but, easy or not, with my two conjectures I am where I wanted to be.

A bank run can be triggered by the failure of one bank. Abstracting from that possibility, though, a run and an isolated failure are two very different happenings. More particular, the failure of one bank, large or small, or of even a few, is not a proper concern of the government. Except perhaps in the odd instance, for although it would certainly seem that every bank has neighboring competitors, there may be a small number that do not.

If a bank fails, then, after the dust has settled, some owners of transactions account balances may have to recognize capital losses. In the immediate aftermath of the failure, all balances, transactions account and other, may be unreachable or unuseable. But it is possible, by making a portfolio adjustment, to recreate a transactions account balance, a buffer stock of means of payment, in a neighboring bank. And quickly! So serious disruption of the payments process cannot result from the failure of one bank.

As I observed above, technological change has considerably reduced the significance of physical distance, at least for banking, and thereby changed the meaning of "neighboring bank." Now, therefore, it must be very nearly right that every bank has neighboring bank competitors. And that virtually every bank has such competitors is a fact, if fact it be, of great importance. I have stressed that, one way and another, banks do most of the settling up in the economy. But so many banks having neighboring competitors implies that, whatever the explanation for why banks are special, the failure of one bank should not concern the government. It may be, as Diamond and Dybvig appear to have argued [1983], that a transactions account balance is (or can with advantage be thought of as being) insurance against uncertainty in desired current consumption.[4] That is an impressive insight. For no one, however, does the opportunity to share risk disappear when one bank fails. Here, that is the essential point. There are other banks near by that can be used, as the failed one was, to insure against uncertainty in consumption.

Inherent Instability

I cannot go on forever, though, ignoring the possibility of the failure of one bank, or perhaps a few banks, resulting in a bank run and, in consequence, widespread failures. What happens after one bank fails is apparently in some part random. Even before the establishment of the FDIC, not every failure resulted in a run. But one outcome is the subsequent failure of many more banks.

When all bank creditors are insured in full by the government or, more accurately, believe with subjective certainty that they are, the probability of a run is zero. It also is if information is costless and, save for the one that has failed, all banks are bound to remain well this side of insolvency over an indefinite future. To assume that information is costless, or that every economic unit is perfectly informed, is dumb, though, particularly when, as at present the concern is financial stability. Far better to assume that information is costly, with cost dependent on the information acquired. And that assumption pretty nearly implies (corner solutions being in some sense rare) not only that economic units are imperfectly informed, but also that a bank run, triggered by the failure of one bank, is entirely consistent with the economist's notorious rationality.

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[4] I say "would seem" only because, although being able to get some quantity of the means of payment more or less immediately may be deemed necessary for an economic unit to be insured, the Diamond-Dybvig bank is in essence a contract between economic units (households) and possibly does not have to fit my or any other traditional definition.

A bank run results in a disruption of the payments process when, because of the run (or the more basic underlying fear of loss), many banks actually fail. It has long been a strongly held part of the conventional wisdom that, absent effective intervention by a lender of last resort, many banks will fail. Nor can there be any wonder why. In the United States, fractional reserve banking—which, as I use the phrase, necessarily involves making risky loans—has from the beginning been universal. If ever there was a bank that, now gone, served when alive as but a large safety-deposit box, it has so far escaped my notice; and for me it is impossible to credit that there are any banks currently serving only as repositories.

There is a tale, to be found in many of our money and banking and other texts, about an especially clever goldsmith of 16th or early 17th century England who invented or anyway discovered fractional reserve banking. As the tale goes, what the fellow did (for the obvious reason it cannot have been a woman) was beat his rivals to the realization that, presumably by the law of large numbers, he could safely lend some of the gold that had been entrusted to him for safekeeping and, furthermore, as we must assume, not have to share his interest income with customers, even by reducing safekeeping fees. In none of the many versions of the tale that I have seen is there so much as a hint of interest being paid, either explicitly or implicitly, to customers (depositor). Happiness is unbelievably casual or dim owners of gold!

It was maybe never intended as history, but the tale of how English-style or fractional reserve banking began can be regarded, quite justifiably, as unfortunate. Or, for the lack of any mention of depositors being compensated for risk-taking, as misleading. We do not have to think of the customers of that especially clever goldsmith as having found out immediately what was going on. It is good enough if somewhere along the way they did, perhaps after the second or third or fourth goldsmith-banking company had gone under.

I am reminded of Sherlock Holmes once having asked, "Why did the dog not bark?" Yes, and why is there not so much as a hint in our textbook tale of the customers of goldsmith-banking companies receiving interest? When Holmes asked his question, he was on to an answer. I do not have even the glimmer of an answer in mind. Nor, surprisingly or not, do I care about why payment of interest on deposits of gold has gone unmentioned. That it has is to me suggestive of what I regard as rather more than an interesting possibility: that, at least in the United States, the riskiness of fractional reserve banking has from the start been more or less effectively disguised; and that, had it not been, we would not now have fractional reserve banking. Believing that, I am clearly at odds with those, Friedman [1959] and others, who believe that such banking is natural or, to be more precise, that it will inevitably be observed in a *laissez faire* competitive equilibrium.

I may seem to have gone mad. In an attempt to keep from being committed, I offer a couple of arguments in defense of my belief. Whether they will be sufficiently persuasive is something else again.

A Theoretical Argument

If lenders are perfectly informed and, as surely is right, there is risk in fractional reserve banking, then even under the *laissez faire* banking policy, we will not observe such banking [see Kareken and Wallace 1978]. Because lenders are perfectly informed, there is no gain for a borrower in taking risk, and therefore a small to vanishing charter value or bankruptcy cost is sufficient for no risk to be optimal. Again, the assumption of perfectly informed lenders (more particularly, bank creditors) is most unappealing. But even a general appreciation of what fractional reserve banking entails, gained perhaps over a period of time, could have a strong effect. I can imagine such an appreciation making fractional reserve banking disappear.

The Seeming Failure of Competition

For my second argument to be worth anything, it must be accepted that U.S. governments have from the beginning been responsive to the wishes of their constituencies. If they have been, then, because protecting against third-party effects is a very recent concern, we get something definite from all of the attempts to make bank balances safe: that safety must have long been very much prized by most, if not all, economic units.

The first attempts by governments date back to the early 19th century [see Golembe 1955 and 1960 and also Wells and Scruggs 1984] New York State introduced its Safety Fund in 1829. The FDIC was established more than 50 years ago. (The FSLIC was too.) And possibly the desire for safe bank balances, revealed by governmental attempts to make those balances safe, is of the past. Arguably, the desire was strong when the only financial assets of most economic units were bank balances and, more especially, transactions account balances, but now, with many economic units having all kinds of financial assets, safe bank or transactions account balances are of no particular appeal. Yet, how our money market mutual funds behaved during the late 1970s, when they were treating banks so rudely, can be interpreted as evidence to the contrary.

The money market mutual funds supplied transactions accounts balances so close to being perfectly safe as to make no never mind; and it cannot be that they were forced to supply such balances. The balances were not insured by the federal government. But, unlike banks, the money market mutual funds were not at all constrained in the rates they could pay. They could have held riskier portfolios than in fact they did and fully compensated creditors. Thus, how the money market mutual funds did business in the late 1970s can be regarded as evidencing a strong, if perhaps inexplicable, desire for safe transactions account balances.

Obviously, what I have alleged—that economic units have all along shown a strong preference for safe transactions account (and perhaps other bank) balances—could be dead wrong. But if I am right, then, for sure, there is a question to be answered. Why have banks never supplied such balances? Within limits, competition supplies autos in the colors of popular choice. It long has. So why has it not delivered safe transactions account balances?

At this writing, there are many economic units with safe bank balances. But that we have the FDIC only makes my question more pointed. Or makes the failure of competition seem all the more apparent. Why did the government have to intervene in 1933? (Not that in the strictest sense it "had to.")

The Bank of England was, in a manner of speaking, conceived in sin. The deal was a charter—or, what may be nearer the mark, a monopoly—in exchange for a war loan and, doubtless, the promise of several more. And we do have a few instances, all from the earliest days, of U.S. governments making banks earn their charters by committing to lend for public improvements, the building of canals and such. Even back then, the concern was, however, much more to protect the balances of depositors than to use those balances to finance economic development. We should perhaps attribute a certain awareness to the state governments of the first half of the 19th century, an awarencess not shared by present-day proponents of anti-red lining provisions: that forcing banks to lend for public purposes is to make depositors or taxpayers bear considerable risk. But if that attribution would be unreasonable, government involvement in banking has to be seen as, from the beginning, a striving to protect depositors, to keep their deposit balances safe. As I noted above, the first deposit insurance scheme, that of the State of New York, was introduced in 1829. And the New York scheme was but the first of many to be introduced. Nor was it only by establishing deposit insurance funds that state governments sought to protect the balances of depositors. The history of portfolio and activities restrictions is indeed a long one. It extends down to this very day.

Save for one difficulty, the case for bank depositors being duped by well-intentioned governments would be easy. There has been more than enough governmental regulation of banks. Or, to put the point another way, there would be an easy answer to why banks have never supplied safe balances. Why bother if customers have been deluded?

And the difficulty to which I alluded? There is no mystery. In the United States, there have been ever so many bank failures; and that being the reality, justifying an unwavering faith in governments as protectors of depositors is not quite like falling off a log. Positing a persistent (and altogether astonishing) blindness is not an attractive way out.

Something of an explanation can, however, be fashioned from a readily apparent pattern in U.S. financial history. Whenever there was a crisis of sufficient proportions, a crisis of which few could have been unaware, government responded. From crisis to crisis, though, the response changed. The response to the crisis of 1907, most belated, comes to mind. Involving the creation of a lender of last resort, it differed markedly from the responses to earlier crises. It is therefore possible to imagine governments maintaining faith by sheer inventiveness.

Often the economic theorist finds it convenient to assume that individuals live forever. That assumption cannot be used, though, in confronting an actual history. As we are all aware, some of us joyously, the lives of individuals are finite. And over the years 1800–1933 many generations appeared and disappeared. Moreover, we know (or I believe we do) that although technical knowledge is easily passed from one generation to the next, there is wisdom that every generation must acquire for itself. And that government is not to be relied on may be a bit of that wisdom. If it is, there is a chance of squaring a continuing belief in the safety of bank balances, a safety guaranteed by government, with a sequence of financial crises.

I cannot pretend to be wildly happy with the arguments I have put forward for what nevertheless seems to me to be a most plausible hypothesis: That, but for the intervention of governments, banks would have come to supply safe or risk-free (transactions account) balances. If I have not been convincing, then there is an intriguing question still to be answered. It cannot be that the demand for safe transactions account or, more generally, bank balances has always been identically zero. But then why have no banks ever supplied such balances? Why has fractional reserve banking been universal? There may be an answer not involving the government, but even if having been unconvincing in my arguments, I for one do not believe it.

HOW BEST GUARD AGAINST WIDESPREAD DISRUPTION?

Some might want to object that I have shown too little respect for the fact that, whatever information may be wanted, it can be acquired only at a cost. Or as that fact can also be put, that information being costly, economic units are in general less than perfectly well informed about the conditions of banks. I wonder, though, just how disrespectful I have been.

There is no denying the possibility of a company being able to profit from deception. But if banks are able to so profit, they are not unique. So we must therefore ask why opportunities to profit from deception, wherever they exist, are not all exploited. It must be that many companies perceive greater advantage in maintaining their reputations.

And Why Not Banks?

There is another point to be made. Above I sought to establish (admittedly, by invoking woefully casual evidence) the existence of a strong preference for safe transactions account balances. And with such a preference, determining the conditions of banks may cost very little. If a bank has decided to supply safe deposit balances, then being entirely open is likely in its self interest.

Of course, if a near-universal strong preference for safe transactions account balances exists only in my imagination, then, for me, the game is up. I do think of competition as, by and large, delivering what economic units want. If the typical economic unit cares, though, not about the riskiness of any particular asset holding, but only about the riskiness of its balance sheet, then there is no reason to expect competition to deliver safe banks.[5]

Wanting a safe transactions account balance is not unreasonable. If having a buffer stock is efficient, why risk having to restore it? But, again, should economic units not care particularly about having safe transactions account balances, then there can be no expectation of competition making (most) banks safe. Nor can it be argued, as I have, that the *laissez faire* banking policy is consistent with (in my sense) financial stability. I am thus obliged to go further and, more specifically, consider how the government ought to try to ensure the soundness of banks.

On the Pricing of Government Deposit Insurance

Of all of the details of our bank deposit insurance scheme, there is one that stands out like the proverbial sore thumb: that the premiums levied by the FDIC are identical across (insured) banks. And that is lamented by many. How much better if premiums varied according to bank risk, or, as might be said, FDIC exposure.

The claim that the FDIC should behave more like a private insurance company, charging relatively risky banks more for deposit insurance than relatively safe banks, is not new. It was made by members of a past generation of academic economists when, in 1933, the 73rd Congress was debating the establishment of the FDIC. But economists, particularly those of academe, are nothing if not faithful. The claim is being made still, and painfully often. Not so long ago, it seemed that the advocates of risk-dependent deposit insurance premiums would soon triumph and could cease their badgering. The rumor was that in its assessment of its deposit insurance scheme—an assessment mandated by the 97th Congress in its Garn-St Germain Act—the FDIC would come out for risk-dependent insurance premiums. In the event, it came out not for such premiums [see FDIC 1983], but only for in effect fining those bank managements that in its judgment were, so to say, bad.[6] We have then come back to square one.[7] Should the FDIC go over to risk-dependent insurance premiums? The question is as pertinent now as it was a while ago.

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[5] But note that a universally strong preference is not required. I argued above that, as regards financial stability, the only legitimate objective of the government is to try to ensure that there is no widespread disruption of the payments process. And if there are only a few unsound or risky banks, then such a disruption is impossible.

For years now, certainly since the passage of FIRIRCA, the Financial Institutions Regulatory and Interest Rate Control Act of 1978, the FDIC has had adequate enforcement powers; more particularly, it has had the authority to impose fines on wayward banks. Yet, in its response to the 94th Congress, the FDIC proposed that it deny (partial) refunds of insurance assessments to those banks alleged to have bad managements. And, despite all the authority it has, the agency could, I suppose, be more effective than it has been if it were able to do that. But as most proponents of risk-dependent insurance premiums would surely agree, it is necessary to go beyond making refunds discretionary. What those proponents have in mind is substituting a new deposit insurance pricing policy for some or (what must be the ultimate hope) all present-day bank regulations, and the elimination of any regulations of consequence requires more of a departure from current policy than simply making refunds discretionary.

I, however, am one of those who doubt that substituting a pricing policy for bank regulations will be a practical option anytime soon. In explaining why I am doubtful, I concentrate on loan quality. That is in part because having made bad loans is, after fraud, the most common cause of failure. Manifestly, if a pricing policy is to be substituted for regulation (by supervision or examination), that policy will have to make *ex ante* lending risk costly. There is another reason, though, for concentrating on loan quality. By doing so, I can most easily explain what I see as the difficulties in replacing bank regulations, some or all, with a sensible deposit insurance pricing policy.

Of all those who have worked on the pricing of government deposit insurance, Kanatas [1984] is, so far as I am aware, the only one who has taken seriously that in the United States there are two federal agencies that insure commercial bank balances, the FDIC and the Federal Reserve. And as he has noted, the introduction of risk-dependent insurance premiums by the FDIC alone could well have little effect. At present, Federal Reserve insurance premiums, implicitly levied, are at best identical across banks and at worst random. There is a strong case, though, for the Federal Reserve having explicit premiums (and I would add, even at the risk of seeming impudent, a much more explicit insurance policy than it has had); there is just as strong a case for it to levy risk-dependent premiums as there is for the FDIC to do so. But if by itself the FDIC goes to risk-dependent premiums, then, and this is Kanatas' point, there will be a temptation for banks—particularly the large ones, but, more generally, those insistent on going their merry ways—to substitute Federal reserve-insured for FDIC-insured balances.

The point is well taken. (I say that even though to the very end of this paper I persist in the pretense that there is but one insuring agency.) And there is an implication. Before the FDIC can go over to risk-dependent insurance premiums, more thought has to be given to whether having two federal agencies insuring bank balances makes sense and, if so, what the joint pricing policy of our two agencies, the FDIC and the Federal Reserve, ought to be. As should be obvious, to say that is not in any way to denigrate Kanatas' pioneering effort.

Throughout the literature on the pricing of government deposit insurance, the insuring agency is represented as being a bank examiner. An essential task is to find out how good banks' loans are. But, then, as Kanatas has also noted [again, see Kanatas 1984], we should want a pricing policy based on what is generally accepted, that every bank knows its circumstances better than does the insuring agency. We should want a policy that provides each bank with incentive to be forthcoming, to reveal what, by its own perception, are its true circumstances, not hide or disguise what has happened to it.

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[6] In its mandated assessment, the FHLBB proposed genuinely risk-dependent insurance premiums. But, there having been a change at the top, it has retreated and is now pretty much at one with the FDIC.

[7] Saying that may be going a bit too far, for a working group of the Cabinet Council on Economic Affairs recently recommended deposit insurance premiums based on "objective . . . easily quantifiable measures (based on publicly available data) of such risks as: credit risk; interest rate risk; leverage risk . . .; and earnings risk."

Our debt to Kanatas grows. Thanks to him, we are clearer than we were about the class of deposit insurance pricing policies over which we ought to be searching in our quest for the best one. Knowing what class of policies to search over is, however, different from having found those that are optimal or, at the very least, would appear to produce reasonable results.

There are many extraordinarily clever economists lounging about (or slaving in) academe. And the United States being so rich endowed, we need not be a long time in getting good answers to those theoretical questions for which, if I am right, we must have answers.

We could be rather a while, though, in figuring out what to make of observations on banks' balance sheets. In the literature on the pricing of government deposit insurance, it is almost always assumed that the insuring agency can use observed outcomes to determine what (risk-dependent) premium each bank should pay. Nor is the assumption all that unreasonable. Abstracting from practical difficulty, observed outcomes reveal bank strategies. In the present context, though, practical difficulty cannot be shrugged off.

To me, it seems that the premium a bank pays should depend, although maybe only in part, on its lending strategy or on how much risk there is in that strategy. Unless I have misunderstood, what the insuring agency wants to do is by its choice of premiums make its expected net income vanish; and presumably that expected value has to be calculated using actual bank strategies, with each of which is associated a distribution of outcomes or payoffs. But an actual outcome does not uniquely determine a strategy, for in general the ranges of outcomes for any two strategic overlap.

Nor, even if many outcomes have been observed, can distinguishing strategies be easy. A change of bank management (and, hence, bank strategy) is not a rare event. And what if the distributions associated with the different strategies change through time. That they do is, I believe, likely.

Even if rated by outcomes, banks presumably will, over a long enough period of time, pay approximately appropriate insurance premiums—provided that their lending strategies do not change. But there is precious little comfort for me in that. In the short-run, a bank that has persisted in a conservative strategy may be punished because it has experienced what, given its strategy, can only be thought of as bad luck.

Risk-rating companies (using industry as one of the determinants) is a possible way out. But I am not optimistic, partly because I see the risk-rankings of industries and, hence, companies as changing through time. Many banks have long been trying, if perhaps in not formal enough ways, to rate industries and, indeed, companies; to date not one of them has been gloriously successful.

I do not say that having risk-dependent deposit insurance premiums is wrong in theory, but only that we are still at some remove from being able to implement a pricing policy that, as most would agree, is right or even sensible. Earlier on, I suggested that there are some theoretical questions to be answered. But, again, what could take much more work or time is figuring out how reliably to identify actual bank strategies.

A Separate Payments Services Industry

I could be too pessimistic about when a well-devised schedule of risk-dependent insurance premiums will have become practical. That is, the best strategy for the present might be simply to put off all regulatory reform until that bright new day, soon to dawn, has dawned.

Or, instead of waiting, the government could attempt to approximate risk-dependent insurance premiums by, for example, requiring every bank to have short-term subordinated or uninsured debt as a proportion of its capital. Even if bank-issued (but not guaranteed by the government), debt is valued according to the riskiness of the issuer. So if a bank had to satisfy a subordinated debt requirement, it would in effect be a paying risk-dependent insurance premium. But not on all of its liabilities. If obvious, that is nonetheless as important point. A subordinated debt requirement would not make risk-taking anything like as costly as having risk-dependent insurance premiums.

There is a second point. It is by no means clear that small banks could comply with a subordinated debt requirement. To which economic units could they sell their securities?

Not yet having even begun a welfare analysis of the various ways in which financial stability (in my sense) might be maintained by the government, I cannot be confident about how those ways compare. I should not be greatly surprised, though, if having the government insure all owners of bank balances in full, but levy risk-dependent insurance premiums, turned out to be other than the best way.[8] I can be more specific. I should not be greatly surprised if forcing a safe payments services industry on the country turned out to be a better way of ensuring financial stability than having the government insure all owners of balances in full and levy risk-dependent insurance premiums.

The proposal that banks back their transactions account balances 100 percent with (perhaps, appropriately dated) Treasury securities [see, for example, Friedman 1959] has been kicking around for a long time, so long a time that, if interpreted literally, technological change has quite overtaken it and rendered it silly. I go back again to when, before the turn of the decade, banks were being outdone by money market mutual funds and getting little help from the bank regulatory agencies or from Capitol Hill. At that time, they were all still subject to restrictions on the rates they could pay. But many were able to fare better than they otherwise would have by becoming practiced in the management of the transactions (then demand deposit) account balances of their customers. They reduced the unit of switching funds between transactions and other types of accounts and, by doing so, effectively increased the rates they paid on transactions account balances.

As will be recalled, it was also back when banks were being outdone by the money market mutual funds that daily "sweeping" of transactions accounts was begun. So we can conclude that out of necessity, during a period of intense struggle, many banks quickly mastered computer-based bookkeeping and, furthermore, that those banks not technologically up to speed, or unwilling to acquire necessary capital, discovered that they could buy such bookkeeping. Now, though, most banks are more the masters of modern bookkeeping than were the most technologically advanced of half a dozen or so years ago. The unit cost of switching funds is at present even lower than it was. My guess is that at present virtually any bank wanting to could continuously maintain zero balances in all of its transactions accounts, and without affecting check writing in the slightest.

Thus, requiring banks to back their transactions account balances 100 percent with Treasury securities might not produce the desired effect. Even with the restriction applying, transactions account balances would not necessarily be safe; nor would a widespread disruption of the payments process be, of necessity, impossible. To eliminate the threat of a widespread disruption, the government would have to require not only that all transactions account balances be backed 100 percent with Treasury securities, but also that any company having transactions account balances could have only transactions account balances. A company with only transactions account balances could not "hide" those balances.

In other words, the government would have to separate the provision of payments services from lending—or, whether actually or only in effect, split the present-day banking industry into two industries, a payments services industry and, what would be part of a larger industry, a bank lending industry.

Splitting the present-day industry may seem like going a long way. Despite having tried hard, I have not, however, been able to find a basis in economics for bank loans being funded with transactions account balances. Recall that in the Diamond-Dybvig setup [1983] what the bank earns is nonstochastic. And recall what in effect I argued in the previous section: that but for government attempts to make bank balances safe, we would today have separate industries; more specifically, we would have a payments services industry providing genuinely safe transactions accounts balances.

And it may well not be politically naive to suggest a forced separation of the provision of payments services and lending. In his "Grandma Jones" speech of a while ago, Representative St Germain [1984], Chairman of the House Banking Committee, threatened a separation, although not quite the one I have suggested. (For certain, he was not motivated by a desire to find the best way of making transactions account balances safe.)

The chairman was upset because, as he believed, banks were borrowing with a government guarantee and yet over-charging poor folk for, among other things, having "insufficient funds." He proposed having two groups of banks. Those belonging to the first group, devoted to doing only good things, providing payments services at fair prices and lending only to members of their respective communities, would be allowed to supply government-insured balances. The banks belonging to the second group, all devoted to doing only bad things, dealing with the affluent and, as lenders, roaming wherever they wanted, would not be regulated in any of their various activities.

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[8] A so-called silent run, a run conducted by owners of balances in excess of $100,000, is currently all we have to fear. But as that fact makes evident, insuring all owners of bank balances in full is required for the probability of a run to vanish.

In reading the St Germain speech, what caught my eye was the suggestion that, if only for the affluent, there should be uninsured and unregulated banks. It takes no straining to imagine XYZ, Inc., a bank holding company, being split up into two wholly owned companies that would have no dealings with each other, the XYZ Bank and the XYZ Financial Service Corporation. The XYZ Bank would have only transactions account balances and, as assets, only Treasury securities; and it would do nothing more than provide payments services. (I hope, for my sake, that "payments services"; is well-defined.) The XYZ Financial Services Corporation would have no government-insured balances, but neither would it be at all regulated.

Were I a banker, I would see a forced split of the sort I have described as the only way to freedom. That is why above I said that to suggest splitting the present-day banking industry into two industries might not be politically naive.

IN CONCLUSION

By way of summing up, I list what I think of as my essential points.

As for the first point: if it is right that nearly all economic units strongly prefer safe transactions account balances, and there is some evidence, albeit indirect, that they do, then the *laissez faire* banking policy could serve us very well indeed. I must concede, though, that changing from the present policy could, for a while, involve some awkwardness.

And as for second point: at this moment, introducing risk-dependent premiums for government deposit insurance, is not a practical option: but it is not wildly unreasonable to conjecture that even if the government could confidently introduce risk-dependent premiums now, it would be better advised to force a split of banking into a payments services industry and a lending industry and, further, to require all transactions accounts balances to be backed 100 percent by Treasury securities.

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Chairman St Germain. Now, we will hear from a familiar face George Kaufman. We have heard from you before. It is good to have you with us again this morning.

STATEMENT OF GEORGE G. KAUFMAN, PROFESSOR OF FINANCE, LOYOLA UNIVERSITY

Mr. KAUFMAN. Thank you, Mr. Chairman.

As usual, it is a pleasure to testify before this subcommittee. Today, I will talk about the stability of the Nation's banking system, and suggestions for reform.

I will summarize my complete statement. As with many things today, there is good news and bad news to report.

First, the good news. The banking system as a whole—generically speaking to include all depository institutions—is stable and not in danger of collapse a la the 1930's. The major difference has been the introduction of Federal deposit insurance.

By both guaranteeing depositors that they will be able to convert their deposits up to at least $100,000 into currency at no loss and, unlike some State or private insurance funds, being perceived by the public as being able to keep this promise, Federal deposit insurance has removed the threat of a run on the banking system as a whole, as opposed to a run on an individual bank or group of banks.

A drain of currency from the banking system was the major cause of the financial holocaust of the 1930's, and is a precondition for individual bank failures to spill over elsewhere. With appropriate Federal deposit insurance, individual bank failures are no longer contagious either to the financial system or to the economy as a whole.

The bad news is that deposit insurance has, at the same time, increased both the risk exposure of individual banks and the burden on taxpayers. Any insurance, be it theft, fire, accident and so on, makes us a little less cautious.

When we have theft insurance, for example, we are less likely to return to our home or car to be sure that we have locked it after leaving. This is also true for banks. Deposit insurance removes the need for insured depositors to check the financial integrity of banks before making a deposit and to look over the bankers' shoulders afterwards.

Nor will these depositors charge a higher rate to riskier banks. This is unlike what we do when we lend equal dollar amounts to others or what banks do when they lend to us. As a result, the good banker is somewhat less restrained in his or her lending, and the bad bank can go "gung ho," particularly in today's environment in which technology permits a bank to attract almost unlimited insured funds almost overnight from anywhere in the world by paying above-market rates.

In such an environment, banks may be expected to fail more frequently, and as we have seen, have done so. And although the failure of any one bank is unlikely to pull down others, bank failures do cause problems for the communities involved and could be a drain on taxpayers' funds. Thus, they are of public concern.

I have recently participated with four other academicians in a major study of bank safety and soundness for the American Bankers Association, and many of my views and recommendations are based on the analysis in that report.

My major contribution to that study was an examination of the theoretical and historical importance of bank failures in American history. I concluded that, with the major exception of the Great Depression, bank failures were both far less frequent and far less detrimental to the economy than commonly believed.

The bank failure rate through the early 1900's was generally below that of nonbank firms, and losses to depositors until the introduction of the FDIC in 1934 averaged only about 0.2 percent of total bank deposits per year and even in crisis years tended to be less than 1 percent of total deposits.

Chairman **St Germain**. Let me interrupt for a moment, if I may, Professor Kaufman. That sounds good, the fact bank failures haven't had that tremendous an effect on the economy. But isn't that because of deposit insurance?

Mr. **Kaufman**. No; this is prior to deposit insurance. This is prior to 1934.

Chairman **St Germain**. Prior to?

Mr. **Kaufman**. Yes, sir.

Chairman **St Germain**. OK; let's take the case of Continental.

Mr. **Kaufman**. Yes, sir.

Chairman **St Germain**. When it appeared as though Continental might fail, weren't there reverberations internationally as far as interest rates were concerned, and wasn't there concern about the value of the dollar.

Didn't they all react to the potential failure of Continental?

Mr. **Kaufman**. Yes, sir; the reaction to all bank failures—the larger the bank that is in trouble, the larger are the ramifications.

Chairman **St Germain**. Wait a second now. The Maryland situation certainly was, you know, very, very frightening and disasterous for a lot of people in Maryland, but when you come right down to it, the size of that was in no way anywhere near Continental.

It was a moderate size situation, so to speak, and yet, the effects of that situation were also felt around the world, because there was a feeling that the entire financial system of this country was about to go belly-up was there not?

Mr. **Kaufman**. Yes, sir.

Chairman **St Germain**. Or an assumption?

Mr. **Kaufman**. I will argue later in this paper that our concern about bank failures is based on a very brief and not representative period in American history, the Depression, when 10,000 or 11,000 banks disappeared, mostly by failure.

The people who lived through it and those of us who have read about it, were so traumatized by that experience that it wiped out our memory of bank failures prior to that.

In that way, I view it quite similar to the Vietnam experience, where the Vietnam war, as far as I can tell, was not representative of past wars and of future wars probably, but so traumatized the people that it has affected our public policy ever since.

One of the points I made in the study for the American Bankers Association, which surprised me because up to that point I had the same feeling you did that bank failures were frequent and very serious. Indeed, the best evidence of that is you could look at my textbook where I have a description of the importance of bank failures, and I talk about the cumulative and contagious effects. I can assure you, in the new edition, which will be out shortly, that will not be there. But one of the surprising things I found out is our fear is based on a unique period.

I don't know how much time you want me to go into this now. I can finish the statement.

Chairman **St Germain**. Go on with your statement, and we can return to this a little later on.

Mr. **Kaufman**. I will. I will be glad to do that, sir.

In fact, the next couple sentences are what I said, so I will skip that over the traumatization, because I think it is very similar to the Vietnam situation, and it has affected our public policy toward banking every since.

Let me comment briefly on one of the issues that you enumerated in your letter, the resolution of bank failures. Economically insolvent banks, the market value of whose assets is insufficient to pay off all depositors in full and on time, should be declared legally insolvent as soon as possible after this fact is established.

The bank should then be recapitalized under new owners, merged or liquidated. Old shareholders should be removed and management changed before they can throw "Hail Mary" passes in a last-minute attempt to regain profitability.

As football fans are well aware, the odds that such passes will be completed are very low. For banks, the most likely outcome of such gambles is larger losses, most likely picked up by the insurance agency and the taxpayer.

If a bank's losses at the time insolvency is declared are greater than its capital, these losses should be shared pro rata by uninsured depositors and creditors, rather than the insurance agency or taxpayer.

All insolvent banks should be treated equally. While large banks, like most large firms of any type, may be too large to liquidate, they are not too large to fail with penalties to shareholders, management, and if necessary, uninsured depositors and creditors.

Unequal treatment of banks according to size will eventually lead to a shift of all uninsured deposits to large banks.

I have proposed elsewhere that to provide the additional time necessary to resolve a failure efficiently, large banks should be temporarily placed in a trusteeship under the FDIC without an interruption in service.

If net worth is negative at the time that the trusteeship is introduced, pro rate "haircuts" should be given uninsured depositors and creditors on the basis of the estimated fair market value of the bank's assets by writing down the value of the deposits on the bank's books.

Although the FDIC would effectively own the bank, it would not engage in day-to-day management. For this, the FDIC would appoint new members of the Board of Directors and new senior management.

It would retain oversight, of course. Except for the removal of the stockholders and possible haircut to uninsured depositors and creditors, such a trusteeship would not look greatly different from the FDIC's solution for the Continental Illinois Bank. I believe that such arrangements are possible under existing FDIC powers.

With respect to your other issues, very briefly: I favor risk-related deposit insurance premiums as well as risk-related capital requirements.

I oppose increasing deposit insurance to 100 percent as both unworkable without additional controls and weakening market discipline.

I oppose reducing deposit insurance greatly as it may encourage a net currency drain from the banking system as a whole.

I favor market value accounting.

I favor making deposit insurance a full faith and credit guarantee of the Federal Government to avoid an Ohio and Maryland type of crisis.

I favor careful monitoring of brokered deposits, but no additional controls other than risk-related insurance premiums and capital. I have elaborated on these issues more fully in my complete paper.

Thank you.

[The prepared statement of Mr. Kaufman follows:]

STABILITY OF THE BANKING SYSTEM: SUGGESTIONS FOR REFORM

George G. Kaufman

(John F. Smith, Jr. Professor of Finance and Economics
Loyola University of Chicago)

Statement Prepared for Hearings By

Subcommittee on Financial Institutions
Supervision, Regulation and Insurance

of the

Committee on Banking, Finance and Urban Affairs

U. S. House of Representatives

September 19, 1985

It is a pleasure to testify before this committee on the stability of the nation's banking system and suggestions for reform. As with many things today, there is good news and bad news to report. First, the good news. The banking system as a whole -- generically speaking to include all depository institutions — is stable and not in danger of collapse à la the 1930s. The major difference has been the introduction of federal deposit insurance. By both guaranteeing depositors that they will be able to convert their deposits up to at least $100,000 into currency at no loss and, unlike some state or private insurance funds, being perceived by the public as being able to keep this promise, federal deposit insurance has removed the threat of a run on the banking system as a whole, as opposed to a run on an individual bank or group of banks. A drain of currency from the banking system was the major cause of the financial holocaust of the 1930s and is a precondition for individual bank failures to spill over elsewhere. With appropriate federal deposit insurance, individual bank failures are no longer contagious either to the financial system or to the economy as a whole.

The bad news is that deposit insurance has, at the same time, increased both the risk exposure of individual banks and the burden on taxpayers. Any insurance -- be it theft, fire, accident, and so on -- makes us a little less cautious. When we have theft insurance, for example, we are less likely to return to our home or car to be sure that we have locked it after leaving. This is also true for banks. Deposit insurance removes the need for insured depositors to check the financial integrity of banks before making a deposit and to look over the bankers' shoulders afterwards. Nor will these depositors charge a higher rate to riskier banks. This is unlike what we do when we lend equal dollar amounts to others or what banks do when they lend to us. As a result, the good banker is somewhat less restrained in his or her lending, and the bad bank can go "gung ho", particularly in today's environment in which technology permits a bank to attract almost unlimited insured funds almost overnight from anywhere in the world by paying above market rates. In such an environment, banks may be expected to fail more frequently, and as we have seen, have done so. And although the failure of any one bank is unlikely to pull down others, bank failures do cause problems for the communities involved and could be a drain on taxpayers' funds. Thus, they are of public concern.

Because banks and any lender effectively deal in futures contracts and the future is uncertain, they assume the risk of not being repaid in full and on time. It follows that such losses will be greater the more volatile the regional or national economy and the riskier the individual loan. Thus, to reduce risk and bank failures, it is necessary to increase overall economic stability and/or to reduce the institution's willingness to make risky loans. The best remedy for reducing anyone's tolerance for risk is to increase the fear and pain of loss. This can be done most effectively in banking by increasing market discipline on all participants -- bank shareholders, bank managers, bank directors, and uninsured depositors and creditors.

I have recently participated with four other academicians in a major study of bank safety and soundness for the American Bankers Association and many of my views and recommendations are based on the analysis in that report. My major contribution to the study was an examination of the theoretical and historical importance of bank failures in American history. I concluded that with the major exception of the Great Depression, bank failures were both far less frequent and far less detrimental to the economy than commonly believed. The bank failure rate through the early 1900s was generally below that of nonbank firms, and losses to depositors until the introduction of the FDIC in 1934 averaged only about 0.2% of total bank deposits per year and even in crisis years tended to be less than 1% of total deposits. Our great current fear of bank failures stems primarily from the dramatic experience of the 1930s, when the number of banks in the country fell from 25,000 to 14,000 -- mostly through failure -- and all banks were closed for all banking business for at least three days. Many communities were without banking services for considerably longer. This so traumatized those who lived through it and those who read about it that it wiped out much of our remembrance of earlier history and has affected our public policy towards banking ever since. In this way, the aftereffects were not greatly dissimilar from those of the Viet Nam war which, although it was not representative of most wars, have dominated our foreign policy since.

Let me comment briefly on the issues that you enumerated in your letter. Perhaps most importantly, economically insolvent banks — the market value of whose assets are insufficient to pay off all depositors in full and on time -- should be declared legally insolvent as soon as possible after this fact is established. The bank should then be merged, sold to new independent owners or liquidated. Old shareholders should be removed and management changed before they can throw "Hail Mary" passes in a last minute attempt to regain profitability. As football fans are well aware, the odds that such passes will be completed are very low. For banks, the most likely outcome of such gambles is larger losses, most likely picked up by the insurance agency and taxpayers.

If a bank's losses at the time insolvency is declared are greater than its capital, these losses should be shared pro rata by uninsured depositors and creditors, rather than the insurance agency or taxpayer. All insolvent banks should be treated equally. While large banks, like most large firms of any type, may be too large to liquidate, they are not too large to fail with penalties to shareholders, management, and, if necessary, uninsured depositors and creditors. Unequal treatment of banks according to size will eventually lead to a shift of all uninsured deposits to large banks. Large banks are unique more in that it takes longer to find an efficient solution to their failures than that recognition of their losses would have proportionately greater detrimental effects on the financial system or the economy.

I have proposed elsewhere that to provide the additional time necessary to resolve efficiently a failure, large banks should be temporarily placed in a "trusteeship" under the FDIC without an interruption in service. If net worth is negative at the time that the trusteeship is introduced, pro rata "haircuts" should be given uninsured depositors and creditors on the basis of the estimated fair market value of the bank's assets by writing down the value of the deposits on the bank's books. Thus, instead of having a deposit of $1,000,000 over the insured $100,000 limit, the depositor would have only $980,000 more if losses were 2 cents on the dollar. Although the FDIC would effectively own the bank, it would not engage in day-to-day management. For this, the FDIC would appoint new members of the board of directors and new senior management. It would retain oversight, of course. Except for the removal of the stockholders and possible haircut to uninsured depositors and creditors, such a trusteeship would not look greatly different from the FDIC's solution for the Continental Illinois Bank. I believe that such arrangements are possible under existing FDIC powers.

Charges for assuming additional risk either or both through risk-related deposit insurance premiums or risk-related capital would discourage banks from making riskier loans as these ventures would now be less profitable. Problems in measuring risk accurately are substantial but not insurmountable, and apply equally to risk-sensitive insurance premiums and risk-sensitive capital. Evaluation of banks' risk exposures is becoming easier almost daily with the increased computerization of banks and increased securitization of their assets. Risk measurement is not unfamiliar to bankers. After all, banks evaluate the risk of all their loan customers, including other banks.

Subordinated debt should be permitted but not required for some proportion of capital. If staggered by maturity, such debt would serve as effective de facto as well as de jure uninsured deposits and strengthen market discipline. It would also be a reasonably cheap form of capital for banks as the interest is tax deductible.

I am opposed to one hundred percent deposit insurance of any type for three reasons. One, bank runs are neither undesirable per se nor excessively damaging. Runs, or better yet the threat of runs, exert market discipline on bank management and, as I have argued earlier, they are unlikely to spread to many other banks. Under federal deposit insurance, fleeing depositors just transfer funds from the bank or banks they perceive to be experiencing financial difficulties to other, perceived safer banks either directly or indirectly through a "flight to quality", particularly Treasury securities, in which the seller of the security redeposits the proceeds in a bank. Two, as risk-prone banks now have the ability to pull funds quickly from anywhere by paying sufficiently high deposit rates, full deposit insurance would require the reimposition of some form of deposit rate ceilings (Regulation Q) to constrain the bank from betting the entire system. Three, one hundred percent insurance on some types of deposits, say transaction deposits, would both require the above and lead to creative redefinitions of deposits to qualify for insurance similar to the creative redefinitions that were designed to evade Regulation Q.

Reducing deposit coverage below $100,000 would increase market discipline, but at some point, and I do not know where, would also provide the incentive for small depositors to withdraw currency from all banks in search of guaranteed safety. This is why private insurance either in full or in the form of co-insurance for the basic deposit amount is not practical. I do, however, favor private insurance as a supplement to federal insurance for amounts above the federally insured maximum. For purposes of both optimum market discipline and equity among banks, it is important that no more than the *de jure* insurance coverage be validated *de facto*. To reduce losses to the FDIC, it should be given the authority to declare banks legally insolvent.

As I have noted earlier, brokered deposits present a problem. However, risk-related deposit insurance premiums and/or capital would reduce this problem substantially. Other solutions would be less efficient. Every Monday my home town newspaper -- the Chicago Tribune -- publishes a list of the five federally insured commercial banks and savings and loan associations throughout the country that pay the highest rates on various types of deposit accounts. One needs only to send one's funds to these institutions in amounts of $100,000 or less. No broker is required. (I attach the listing from the Chicago Tribune of Monday, September 16, 1985. It is of interest to note that some institutions pay 200 basis points above the national average. While the depositor can guess what the bank may be doing with the funds, he or she doesn't really care.)

Market value accounting is another idea whose time has come. Only market values provide an accurate picture of an institution's financial condition. Bankers are aware of this when they analyze the financial statements of their loan customers, particularly of those customers who borrow to purchase stocks. Indeed, for such loans they will liquidate the position when the stock price falls below the loan amount. Market values are necessary both for intelligent internal bank management and for the determination of accurate risk-related deposit insurance and capital by regulators. Moreover, meaningful information about banks is a prerequisite for effective market discipline by depositors. For many bank assets and liability accounts, market value accounting is not difficult. For accuracy, it is important to include off-balance items as well as on-balance sheet items. Market value accounting would reduce the need for banks to sell their buildings in order to recognize the appreciation as a number of banks, including BankAmerica, have recently done. The gain would already have been recorded without the costly and inefficient "game playing". It may be desirable in the transition from book to market value accounting to have banks provide market values to the public voluntarily.

Monitoring by bank regulators would be considerably easier under market value accounting. Increased monitoring is desirable, particularly for verification of account values and the existence of appropriate controls. A combination of market value accounting and increased monitoring should obviate the need for increased heavy-handed government supervision.

In order for the good news about the stability of our banking system to remain good, it is important that the public not become concerned about the financial health of the federal deposit insurance agencies. Otherwise, we will have a replay of Ohio and Maryland, where depositors correctly doubted the ability of the insurance agencies to live up to their commitments. To allay any potential similar fears nationally requires a follow-up to the Joint Congressional Resolution of 1982 making deposit insurance a full faith and credit guarantee of the federal government. Now is the time to do this. The individual insurance agencies should maintain their separate identities, however, and impose their own insurance premiums, regulations, supervision and failure resolutions. Depository institutions should be able to choose between the FDIC and FSLIC according to the premiums and other terms of the insurance. This would provide an element of competition, which is important for the protection of the banks. Underpricing of premiums could be prevented by imposing high penalties on the agency's managers for losses.

These are difficult subject areas, and I cannot do justice to them in this brief statement. I have discussed many of these more thoroughly elsewhere, and I attach a listing of some of these studies. Nor are the solutions simple. If they were, it is likely that we would have adopted them by now. But they will not get any easier by waiting. Indeed, both the problems and the solutions are likely to become more complex. Transition problems are always troublesome when we introduce change. But as President Jack Kennedy was fond of reminding us, "a journal of a thousand miles begins with a single step".

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22 Section 4 Chicago Tribune, Monday, September 16, 1985

Personal finance

Banks vs. money funds

Bank-thrift yields

Highest yields reported by federally insured banks and thrifts as of Sept. 11, based on stated rates and method of compounding for lowest minimum deposit available. Figures in parentheses are average annual effective yields offered by 50 large banks and thrifts in the top five markets. Individual yields for 2.5-year and 5-year CDs are average annual interest earned over entire life of account, not "annual effective yield," which would only show interest earned the first year.

MMDA annual effective yield [Nat'l avg. 6.90 pct]

State Federal Savings, Corvallis, Ore	8.95
Audubon Federal S&L, Metairie, La.	8.87
Crescent Fed Svgs Bank, New Orleans, La.	8.80
Meridian Savings, Arlington, Tex.	8.80
Northpark Savings, Dallas, Tex.	8.57

6-month CD annualized yield [Nat'l avg. 7.68 pct]

[Annualized yields are for 12 months, and are based upon rate in effect at time account is opened.]

Pacific Coast S&L, San Francisco, Calif.	9.14
Murray Savings, San Antonio, Tex.	9.14
Northpark Savings, Dallas, Tex.	9.08
Commerce Savings, Dallas, Tex.	9.04
Sun State Savings, Phoenix, Ariz.	9.04

1-Year annual effective yield [Nat'l avg. 8.11 pct]

Great American Fed of Corinth, Corinth, Miss.	9.85
Savings of America, Dallas, Tex.	9.58
State Federal Savings, Corvallis, Ore	9.56
Western Savings, Houston, Tex.	9.56
Pacific Coast S&L, San Francisco, Calif.	9.42

[Average Annual Yields below show the average yield per year over the life of the CD. The total interest earned on the account is divided by the number of years of the CD, and the result is the average annual yield in percentage terms].

2.5-Year avg. annual yield [Nat'l avg. 9.49 pct]

[Average annual interest earned over entire life of account.]

Mercury Savings, Garland, Tex.	11.04
Great American Fed of Corinth, Corinth, Miss.	10.89
State Federal Savings, Corvallis, Ore	10.89
Mentor Savings Bank, Washington, D.C.	10.89
Charter Savings, Corpus Christi, Tex.	10.89

5-Year avg. annual yield [Nat'l Avg. 11.71 pct]

[Average annual interest earned over entire life of account.]

Columbia S&L, Beverly Hills, Calif	14.01
United Savings, Rockville, Md.	13.70
Gill Savings, San Antonio, Tex.	13.60
New South Fed Svgs Bank, Birmingham, Ala.	13.58
Guardian Federal S&L, Bridgeport, Conn	13.38

$100,000 CDs [annual yield]

1-month

Mercury Savings, Garland, Tex.	8.75
Alamo Svgs of Texas, San Antonio, Tex.	8.75
Alliance S&L, Houston, Tex.	8.70

3-month

State Federal Savings, Corvallis, Ore	9.25
Centennial S&L, Santa Rosa, Calif	9.00
Stockton Savings, Ft Stockton, Tex.	9.00

6-month

State Federal Savings, Corvallis, Ore	9.30
Centennial S&L, Santa Rosa, Calif	9.25
Security Savings, Texarkana, Tex.	9.25

Money fund yields

[10 highest 7-day compound yields for period ended Sept. 10]

Government-only money funds [Avg. 7.10 pct]

Renaissance Assets Trust/Gov't	[illegible]
Vanguard M.M.T. Federal	[illegible]
Dreyfus M.M. Instruments Gov't	[illegible]
Equitable M.M.A./Gov't Sec. [N]	[illegible]
Lehman Gov't Fund, Inc.	7.58
DBL Cash Fund Gov't Sec. Port.	7.57
Mariner Government Fund	7.56
UMB Money Market Fund Federal	7.56
Shearson Gov't & Agencies	[illegible]
Mariner U.S. Treasury	7.40

General purpose money funds [Avg. 7.30 pct]

Transamerica Cash Reserve	7.99
PRO Money Fund/Prime Port. [N]	7.98
Flex-Fund M.M.F. [N]	7.88
Sigma Money Market Fund	7.85
Renaissance Assets Trust/M.M.F.	7.75
Pacific Horizon Funds/M.M.P.	[illegible]
Kemper Money Market	[illegible]
First American Money Fund	[illegible]
Trinity Liquid Assets Trust	[illegible]
Cash Reserve Management	[illegible]

Tax-free money funds [Avg. 4.77 pct]

Financial Tax-Free Money Fund [N]	5.50
USAA Tax-Exempt M.M.F.	5.44
Benham Nat'l T-F M.F. [N]	5.43
Cardinal Tax-Exempt Fund [N]	5.28
Municipal Cash Reserve Mgt	5.22
Seligman Ca. T-E M.M. Ser	5.21
Fidelity Tax-Exempt M.M. Trust	5.14
Calvert T-F Reserves M.M.	5.12
Mariner Tax-Free M.M.F.	5.05
Money Management Plus/T.F. [N]	5.02

Addresses and phone numbers of federally insured high yielding bank-thrift MMDAs and CDs, and money funds, are available at $12 each. Send payment to Directory, Box 105194, Atlanta, Ga. 30348, or call 1-800-554-7800 [operator 102] and charge your directory to Visa or MasterCard. Directories will be shipped to you immediately via first-class postage.

[N] Sources: 100 Highest Yields, North Palm Beach, Fla. 33408, 800-327-7717, and Donoghue's Moneyletter, Holliston, Mass. 01746, 800-343-5413

Chairman St Germain. Thank you, Professor Kaufman.

Now, we will hear Professor Pyle, who is professor of banking, University of California at Berkeley. We will put your entire statement in the record. You may proceed.

STATEMENT OF DAVID H. PYLE, PROFESSOR OF BANKING, SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF CALIFORNIA AT BERKELEY

Mr. Pyle. Thank you very much, Mr. Chairman.

The Federal Deposit Insurance System has served this country well over the past 50 years. These hearings reflect the justifiable concern about the current state of that system, and the need for deposit insurance reform.

I am pleased to have this opportunity to participate in your deliberations on this subject. I believe it is important to distinguished between two aspects of the policy problem that you face.

One is the goal or goals of deposit insurance reform and the changes in the deposit insurance system that are necessary to achieve those goals.

And the second involves what can and should be done now that will move us toward achievement of the longrun goals. My remarks today are directed at changes in the deposit insurance that I believe are necessary to meet the joint goals of putting that system back on a sound financial basis, while insuring that it promotes stability and economic efficiency in our financial system.

I address the points that were in the letter in three groups: Insurance fund proposals, risk-sharing proposals, and proposals for changes in the deposit insurance and regulatory system.

Would the insurance fund proposals, that is, fund merger or fund recapitalizations, move us toward the goals that I have stated?

My answer is not very much. They might be useful in terms of the cost of reaching those goals, but they don't address the fundamental issues of preventing future fund attrition or removing perverse risk incentives.

The second set of proposals I turn to are the risk-sharing proposals in which I include modified payout, reduced coverage, private insurance and subordinated debt.

Would these risk-sharing proposals, these suggestions that we can get someone else to burden some of the risk of failure in our insured financial institutions, would they contribute to the achievement of the goals that I have mentioned?

My answer is only a qualified yes, and with a preference for subordinated debt. The preference is based on the superior loss sharing nature of subordinated debt and the fact that it is less susceptible to runs.

One point that I want to make about these risk-sharing proposals is that if we try to create an at-risk set of uninsured depositors, we have to be willing to accept the fact that they will try to get out of these institutions faster than they can be closed down. Continental gives us a good example of how that works.

But none of these risk-sharing proposals alone can fully solve the problem if we still have improperly priced insurance. This takes us then to proposals for risk adjusting.

What is clear to many academics who have studied this problem is that there are a lot of ways to change the risk to premium relationship in deposit insurance. There are really four major tools that are available to us to make those changes.

We can do something about the controls that we have. We can do something about the premium, for example, risk-related premiums.

We can do something about portfolio risk. That is whatever premium we have, we can try to bring portfolio risk into proper relation to that premium.

If we do that, we are still going to have to pay attention to leverage, because portfolio risk and leverage combined give us the total risk of the deposit insurance contract.

And finally, we have a fourth control variable, which is monitoring frequency. How often do we test to see whether this bank is still sound or not? In principle, deposit insurance can be brought in line with the deposit insurer's liability by using any of these four controls in different combination, so the decision has to be based, I believe, on the costs of implementing the policy.

I believe that we need such a policy change, that is, we need to eliminate the risk incentives in the deposit insurance system, but I don't think that any one particular method is necessarily better than the others until we have examined the costs.

My own particular view is that capital regulation, especially with subordinated capital, may prove to be the least costly method, but I think there is something more fundamental that we have to look at here.

First of all, if we accept the principle that the system must be changed to remove these risk incentives, then to make any control system work, no matter which one we are talking about—whether we are talking about our current system under which the risk is supposed to be or at least should be commensurate with the flat rate premiums that are being charged—or we are talking about a system with a risk-adjusted premium—or we are talking about a system in which we try to reduce the leverage in the institutions to make the overall risk consistent with the premium. Whatever control system we decide to take, we need to measure portfolio risk as well as we can, as accurately as we can, and we need to measure the market value of assets in the institutions. These are fundamental requirements of any such control system.

Another point I want to make, and this really is the major point that I want to address to the committee today, is that whatever set of controls we try, to eliminate this risk incentive problem, it is essential we adopt a market value rule for the closure decision.

George Kaufman touched on this, and I think it is a keystone in what we are talking about. What I mean is that the decision to close an institution or to force its recapitalization has to be based on the market value of that institution.

It can be shown that a closure policy that systematically results in asset realizations that are less than covered deposit claims greatly increases the deposit insurance subsidy, much more in my opinion than the problem of portfolio risk.

So, the use of book value standards in closing these institutions virtually insures the market worth of insured institutions that are closed will be systematically and significantly negative.

The policy proposals in this area are usually——

Chairman **St Germain**. Excuse me. Professor Pyle?

Mr. **Pyle**. Yes?

Chairman **St Germain**. A lot of people define book value standards differently. Would you at this point give us your definition of book value standards?

Mr. **Pyle**. Well, what I am speaking of currently are the book value standards, the accounting principles that are being recognized by the deposit insurance corporation, the Federal Deposit Insurance Corporation, and the Federal Savings and Loan Insurance Corporation.

You know, when someone says——

Chairman **St Germain**. Give us a specific example.

Mr. **Pyle**. I will give you a specific example. When somebody says the regulatory capital of a particular bank is being increased to 6 percent, they mean by that by some measure of book value that capital is 6 percent.

We have, for example, in California, just seen—it is not the only place it has happened—the following kind of response to that situation:

A bank that sells its building and leases it back. In economic terms, nothing has happened to improve that bank. Its book value is certainly going to increase, and its book value of capital is going to increase, because it was carrying that asset on its books at $79 million, and sold it for $660 million.

Chairman **St Germain**. Professor Pyle?

Mr. **Pyle**. Yes, sir?

Chairman **St Germain**. I asked you to define what you mean by book value.

Mr. **Pyle**. Yes.

Chairman **St Germain**. By book value, do you mean that you take the price that was paid for the building originally, and then decrease that by the amount of depreciation or by the amount that has been paid on the mortgage or what?

I am asking you to define book value for us.

Mr. **Pyle**. Well, in that particular example, the book value of that property is the depreciated original price of the property.

Chairman **St Germain**. Therefore, if they paid $79 million originally, the book value——

Mr. **Pyle**. They paid more than $79 million originally.

Chairman **St Germain**. But it had been depreciated down to $79 million, so that is what you mean by book value.

Mr. **Pyle**. And I am making the point to you that in that particular case, that is the way our capital rule for that institution works. Presumably if we monitor that institution for closure, that is the value of that asset that people are going to be looking at.

In this particular case, it works to the advantage of the institution to convert that asset from that book value into a market value and get an increase in the reported, or in that case, in the book value of the asset on their books.

Chairman **St Germain**. One more question, and then I will ask you to proceed.

Mr. **Pyle**. Yes.

Chairman **St Germain**. Did I understand you correctly to say that the regulatory agencies should make a decision to close the institution based on a book value standard?

Mr. **Pyle**. No.

Chairman **St Germain**. Did I write this down wrong?

Mr. **Pyle**. I said quite the opposite. I said they should stop using that standard and turn to a standard that is based on a best estimate of market value.

Chairman **St Germain**. And at a particular point in time?

Mr. **Pyle**. At any time they look at it, and they discover the market value of the assets are not going to cover whatever depository claims are going to insurance, explicitly or implicitly, then we should invoke closure.

Chairman **St Germain**. I am going to ask for the indulgence of the subcommittee. So, now, we are talking about the market value of the assets?

Mr. **Pyle**. Exactly.

Chairman **St Germain**. That is the best estimate of the market value?

Mr. **Pyle**. Absolutely.

Chairman **St Germain**. All right. So, the FDIC comes in, or the Comptroller comes in, or the FSLIC comes in and says you have gone below the market value standard that we have set; therefore, we are taking over.

Mr. **Pyle**. No. We don't have to go that far. We can say, "You have gone below those standards. We want you to recapitalize. If you don't recapitalize, we are going to——"

Chairman **St Germain**. It is not always all that easy to recapitalize, as we have seen, because over the years, we have had so many institutions. People come in and say we were about to recapitalize, but there isn't enough time. They were asking to recapitalize at too high a figure, and then they shut the institution down. They didn't allow them the time. That is why I ask this question.

My problem—of course, this is a legal problem I have and I don't know if you have ever considered it. If we were to adopt such a policy, if the regulatory agencies were to adopt such a policy, wouldn't we be spending a lot of time in the courts, where stockholders would go to court and say, the FDIC, the Comptroller, or the FSLIC, have shut us down, but they shouldn't have shut us down because our market value was not that low.

Mr. **Pyle**. We already are spending a lot of time in court, and perhaps too much, but if the Congress—if this idea is sound, the Congress can make law with respect to this particular kind of closure or bankruptcy that is different from other——

Chairman **St Germain**. Don't get me wrong, Professor. I am not disagreeing with you on this, but you have to play the devil's advocate and look at the other side of the coin and ask, what are the deficiencies here?

The problem is that you say they are spending a lot of time in the courts now, nowhere near as much time, in my opinion, as we would spend if we were to try—see, it is like trying to come up with intent.

What was somebody's intent? That is very difficult. Blood pressure, you can measure, right? Pulse, you can measure, but intent is another thing. I am afraid that market value is one of those things that would be very, very difficult to determine.

It is like risk-related premiums. It sounds great, but who is going to make that determination as to which institution is taking more risks or what amount of risk? Sorry to interrupt.

You can proceed, but we will have more discussion in the question-and-answer period.

Mr. PYLE. I will be glad to. Well, as I was saying, policy proposals about the topic I am speaking of are usually stated in terms of market value accounting. Market value accounting may be useful in conditioning institutional behavior, but it is not really the issue.

The real issue is that we need an appropriate closure policy that will require the regulators to monitor capital on their best estimates of market value of that capital with the clear legal authority—this addresses the issue I think you were making—they need the clear legal authority to demand recapitalization or failing that, closure on the basis of those estimates.

Now, the point I made earlier, I would repeat again, namely that we don't avoid this problem of measuring market value in our current system. We don't eliminate the problem by saying it is hard to do.

It certainly is hard to do, but the fact is the system that we have now will continue to have risk incentives associated with it unless we find a way to deal with market value of the assets of these institutions.

So, I suggest that we should be moving toward that goal fully realizing it is difficult to do today. It is difficult to do today, given the condition of many of the institutions that are insured.

That doesn't mean that we couldn't set out on a route that lead us to it eventually. Thank you, Mr. Chairman.

[The prepared statement of Mr. Pyle follows:]

Deposit Insurance Reform

A Statement Prepared for the Subcommittee of Financial Institutions, Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, U.S House of Representatives, Ninety-Ninth Congress.

The federal deposit insurance system has served this country well over the past 50 years. Over the past two decades, dramatic changes in the financial services industry and in the economic environment in which it operates have severely strained that system. Deposit insurance reform is urgently needed.

The system is flawed by the use of deposit insurance premiums that are not risk related. The importance of this problem has increased with increases in the risk-taking potential of insured institutions and in the competitiveness of financial markets. Critics of the existing system who suggest that the failure to keep portfolio risk commensurate with the statutory premium has contributed to the current situation in which the unrealized liabilities of the insurance funds outstrip the assets in those funds are correct. However, there is a more important and fundamental cause of the perilous condition of the insurance funds and that is the systematic failure to close or recapitalize insured institutions before the market value of their assets falls significantly below the value of covered liability claims.

It is important to distinguish between two aspects of the deposit insurance problem. One is the goal (or goals) of the deposit insurance reform and the changes in the deposit insurance system that are necessary to achieve those goals. The second involves what can and should be done now to move us toward achievement of the goals. My remarks today are chiefly concerned with the first of these two aspects of the problem.

Specific reform proposals fall into three categories--insurance fund proposals, risk-sharing proposals, and proposals for changes in regulation and supervision.

Insurance Fund Proposals

Fund recapitalization and fund merger have been proposed as ways to improve the deposit insurance system. There is a sense in which either of these steps would be cosmetic. They won't change the reality of insured depositors' claims on the deposit insurance system and ultimately on the U.S. taxpayer. Nevertheless, there may be merit in any step that will reinforce small depositors' confidence in this guarantee. More importantly, as an insurance fund gets smaller, decisions on how to deal with weak and failed institutions are increasingly directed toward preserving the fund in the short-run rather than at minimizing the ultimate cost to the government. Fund recapitalization and, to a lesser extent, fund merger have a role to play here.

Risk-sharing Proposals

The idea in all of the risk-sharing proposals is to get agents other than the federal government to share in the risk of depository institution failure. Usually it is assumed that these other agents will also assist in the monitoring function. Under modified payoff and reduced deposit insurance coverage, the other agents are uninsured depositors.

Any scheme that depends critically on putting uninsured depositors at risk will work only if the regulators, and ultimately the Congress, are willing to tolerate bank runs. Deposit runs have been rare at federally insured institutions because almost all depositors have been fully insured, either explicitly or implicitly. Once they conclude they are not fully protected from loss, uninsured depositors will try to get their funds out of institutions that they perceive to be in trouble. These runs are not likely to be as rapid or dramatic as the recent thrift runs in Maryland and Ohio, but we have seen in the case of the Continental Illinois Bank that a so-called silent run can precipitate a liquidity crisis. Of course, this could be just what the financial doctor ordered, the regulators' attention is drawn to a serious solvency problem by alert private sector depositors and the chartering agency moves rapidly to close or recapitalize the institution while there are enough uninsured deposits still around to absorb a significant fraction of any loss. It didn't work that way at Continental Illinois so there have to be doubts whether regulators and legislators will accept bank runs, silent or noisy, no matter how cathartic they might be.

It is not clear that reducing the deposit insurance coverage per account would do much except increase the revenues of the postal service and the telephone companies. There is a cost to maintaining more than one account to stay fully insured, but not a cost that would induce currently insured depositors to accept a share of the risk of failure. A limit on the deposit insurance coverage per individual would be more effective in reducing system exposure if a workable method of controlling individual coverage could be devised. However, it is not clear what that maximum coverage should be. It can't depend only on the effect on institutional risk-taking. The optimal amount of deposit insurance per individual must also depend on total monitoring costs and more uninsured depositors would mean more total monitoring costs.

Reducing maximum coverage per account would constrain and perhaps eliminate the brokerage of insured deposits by making reallocation of a large investment into fully insured accounts more costly. Whether it is desirable to eliminate deposit brokerage by this or any other method is another question. Insured deposit brokerage gives smaller institutions access to national markets in much the same way that direct sale and brokerage of negotiable CDs have given larger institutions national access to corporate, institutional and individual savings. Both markets work because depositors have little concern about losses due to bank and thrift failure. In this sense, the implicit guarantee of the liabilities of large institutions is functionally equivalent to the explicit insurance of the deposits of smaller institutions at an account size that permits brokerage to take place. There is an alternative solution to the brokered deposit problem. An actuarily sound system of deposit insurance would solve it without interfering with the opportunity to tap national deposit markets.

Private deposit insurance is a third approach to risk-sharing. An uninsured depositor must determine whether a depository institution will remain solvent. A privately-insured depositor must determine whether the private insurer of that institution's deposits will be able to meet its obligations. It is not clear that the second of these determinations would be easier to make, except where information on the reliability of the insurer is easier to obtain than information on the depository institution. A second problem in private insurance schemes is who would have the authority to force a bank or thrift closure. How could a private deposit insurance company control its risk exposure unless it, and not the chartering authority, had the right to force closure?

Subordinated debt has distinct advantages over uninsured deposits as a method of risk-sharing. Until the maturity of subordinated debt gets short, the regulator has time to discover a troubled bank or thrift before the debt holder can slip away. The debt holders have good reason to monitor the bank or thrift whose debt they hold and the effect of that monitoring on the price of the debt is a useful signal for the institution's regulator. Furthermore, truly subordinated debt can be forced to absorb losses up to the amount of that debt rather than to share those losses *pari passu* with the federal insurer. Of course, subordinated debt won't be of much help to an insurance fund if the debt holders get bailed out along with the depositors.

Risk-sharing alone will not completely solve the risk incentive problem. An effective risk-sharing scheme would impose costs on riskier institutions and probably reduce their propensity to take risks. However, an incentive to take risk remains unless deposit insurance premiums and the institution's riskiness are appropriately related.

Changes in Regulation and Supervision

The risk incentive in flat rate deposit insurance can be eliminated either by making the risk to the insurance fund commensurate with the statutory premium or by charging variable premiums that are commensurate with the risk imposed on the fund. Since the risk is made up of two components, portfolio risk and leverage, the regulator has both of these tools as well as the size of the insurance premium to work with. Risk-related premiums use the insurance premium as the control variable and risk-related capital uses leverage while intensified supervision focusses on bringing portfolio risk in line with the statutory premium. There is a fourth control variable, monitoring frequency, that is less often mentioned but is worth considering.

In principle, the deposit insurance premium can be brought into line with the deposit insurer's liability from a given institution by using these four controls in different combinations including the use of any one alone. The decision on which to use should be based on the costs of implementing the policy and it is not obvious which method or combination of methods would be least costly.

Capital regulation has natural advantages as a control variable, at least at institutions with publicly traded debt and equity. The argument for this centers on the cost of capital regulation for the insured institution and on monitoring costs.

A case can be made that capital, especially subordinated debt capital, is not costly compared to properly priced deposits. In this view, institutional reluctance to add debt capital is related to the risk subsidy on implicitly insured negotiable CDs and other money market liabilities. Since that subsidy is what we are trying to eliminate, the claim that debt capital is costly compared to deposits is not a valid argument against this approach. Within reasonable limits, the addition of subordinated debt will improve the quality of uninsured deposits so increased capital need not be costly to the institution. The higher debt cost is offset by a lower cost on uninsured deposits. In contrast, a risk-related insurance premium in excess of the proper risk-adjusted premium is a cost to the institution without an offset.

A second advantage of capital regulation in the case of publicly traded firms is that the market value of that capital and its price volatility provide a low cost monitoring device. In contrast, greatly intensified supervision in the form of on-site examinations would significantly increase the cost of managing the deposit insurance system. With a low cost monitoring device, it is economical to use monitoring frequency as a risk-related control. Institutions that are perceived to be taking greater portfolio risk based on the price volatility of their traded capital would be required to meet a capital test more frequently.

It is important to recognize that any control system that will remove the risk incentive in deposit insurance, including the improved supervisory risk control that would be needed to make the current system work, requires someone to make estimates of portfolio risk and of the market value of assets of insured institutions.

Furthermore, whatever set of controls is used to remove the risk subsidy, it is essential to adopt a market value rule for the closure decision. The term "closure decision" in this context does not necessarily mean a decision to shut down the institution in question. Rather in most cases it would be a decision to force recapitalization through a capital infusion by existing owners or through acquisition by new owners or by some other means. It can be shown that a closure policy that systematically results in asset realizations that are less than the covered deposit claims greatly increases the deposit insurance subsidy. My research suggests this effect is substantially more important than excessive portfolio risk in increasing the federal deposit insurance liabilities. The use of book value net worth standards virtually assures that the market net worth of insured institutions that are closed will be systematically and significantly negative. The policy proposals in this area are usually stated in terms of market value accounting. Market value accounting may be useful in conditioning institutional behavior, but is is not really the issue. An appropriate closure policy need not involve market value accounting on the part of the institutions; it just requires the regulators to monitor capital on the basis of their best estimates of the market value of that capital with the clear legal authority to demand recapitalization or, failing that, closure on the basis of those estimates.

Summary

This brings us back to the point about goals and tactics made in the introduction to my statement. Deposit insurance reform will have little effect on the federal deposit insurance liability unless a policy is adopted that results in closure or recapitalization before the economic value of an insured firm's assets falls significantly below its covered deposit claims. A market value closure rule must be a goal of deposit insurance reform. It may be impossible to reach this goal today, but Congress could, and I believe should, move toward that goal for example by requiring the chartering authorities to adopt a market value closure rule for all insured institutions by a known date, say three to five years hence.

David H. Pyle
Booth Professor of Banking and Finance
School of Business Administration
University of California, Berkeley

September 19, 1985

Chairman **St Germain**. Thank you, Professor Pyle.

Now, I would ask all four of you to put yourselves in our shoes. We have listened to four distinguished scholars. We listened to four distinguished scholars yesterday. We are going to listen to more distinguished scholars.

I can assure you of one thing, and that is that I am having a great deal of difficulty finding opinions that really come together. Now, Ms. England, as you recall initially, dismissed market value accounting—didn't dismiss it, but she just said, don't put too much emphasis on it.

Am I quoting you correctly?

Ms. **England**. Right.

Chairman **St Germain**. Now, we go to Professor Pyle, and he is emphasizing market value accounting. Really and truly, just think of the dilemma we are faced with here. Here, you people are giving us your best opinions. You are doing your utmost to assist us and for that, we are grateful, but I am having a problem finding—for instance, Professor Kaufman, private insurance was mentioned yesterday by Professor Edward Kane.

He spent quite a bit of time on private insurance. I didn't hear you, Professor Kaufman, spend very much time on private insurance.

What is your feeling about private insurance either as a supplement or perhaps as a total?

Mr. **Kaufman**. Thank you. As a supplement, I think it is fine, to add to basic Federal insurance. I think it does not work in total for the following reason: My examination of American history shows that contagiousness occurs when there is a run from the banking system as a whole, when people take currency out of the banking system and do not redeposit it elsewhere.

In that case, you have a contraction of deposits, a contraction in the money supply, and fire sale losses as banks try to sell assets to meet their currency outflow.

In order to avoid a currency outflow, the public has to have faith that the insurer can meet the liability in full and on time.

As we saw recently in Maryland and Ohio that depositors believed, rightfully so in retrospect, that the insurance agencies did not have the funds, consequently, they said, let me transfer the funds to institutions where the insurer does have the ability to meet the promise, and the only persons or the only agency in the United States that has the ability to meet all promises on time and in full is the U.S. Government.

Mr. **Kareken**. If I might, it is not they didn't have the funds; it is that they were clear that Ohio and Maryland were not going to tax to pay them off.

Chairman **St Germain**. That is because it is a private insuring fund, not a State fund.

Mr. **Kareken**. I mean it is the power to tax, to redistribute income that is the basis for confidence.

Chairman **St Germain**. As far as federally insured institutions.

Mr. **Kaufman**. But that is precisely why private deposit insurance must ultimately fail, because unless there is re-insurance by the Federal Government, which then makes it something of a joke, you have to have the power to tax to make deposit insurance credible.

Chairman **St Germain**. Ms. England.

Ms. **England**. Yes.

Chairman **St Germain**. I couldn't deny you.

Ms. **England**. May I please comment? True, there were problems in Ohio and Maryland, but I don't think we should throw out the baby with the bathwater. We should try to learn from those experiences and I think the great advantage of private insurance is being able to limit runs.

If we talk about a systemwide run, I will be among those who admit that there is no way that a private guarantor system can deal with a systemwide crisis like that we experienced during the 1930's.

You must have the ability to tax and to create money in order to deal with that sort of problem, but if we are talking about limited failures among one or two institutions that have problems, private guarantors have dealt with those problems.

The credit union industry has a very active system with both private and Federal insurance. Private insurers of credit unions have dealt with institutions they had to liquidate. Private guarantors have dealt with private institutions they had to merge. Admittedly, the credit union industry is very different, but we do have some experience where private insurance has worked on a limited basis.

So, admittedly, if we look at systemwide failures, ultimately the Federal Government would have to pick up the bill in that case, but if we are talking about guaranteeing deposits in isolated failures——

Chairman **St Germain**. Ms. England, how do you insure against a systemwide failure? Let me cite something to you. The State of Texas recently adopted legislation that would create a private insuring fund because they want to be able to continue to do some absolutely wild things with their S&L's.

They want to invest in—I mean, they are buying the Brooklyn Bridge every day. So, they adopted the legislation to create a private insuring fund. What guarantee do they have that any institution that has been allowed these extraordinary investment powers would not be able to outbuy their private insuring fund?

What is so peculiar about it is the fact that—you know, it doesn't impress me a bit, because it is a call. It is a call on the existing institutions. Can you see a call on the S&L's in Texas right now? Wouldn't that be effective?

Who are we kidding? That is the problem. How do you insure against a great run on a private insuring fund? You tell us how you accomplish that, a systemwide failure. That is the terminology.

Ms. **England**. Statewide failure like that we had in Ohio?

Chairman **St Germain**. A private insuring fund would not be limited to a State, would it?

Ms. **England**. No; I would like to see them diversify across State lines.

Chairman **St Germain**. It would be national?

Ms. **England**. Right, but not one insurer. First, as I mentioned in my testimony, I think the first line of defense against systemwide failure in the future is having institutions that are more heterogenous, that we don't view all savings and loans as being like all other savings and loans that they have more diversified portfolios so that there is, first, less of a perception on the part of the public that the depository institutions are all the same.

That requires education and experience. That is why I wouldn't suggest private guarantees be introduced tomorrow.

Second, then you wouldn't have situations like you have with the savings and loans, where the housing industry and interest rate fluctuations endangered the system as a whole.

As long as all institutions look the same, we have the problem, the potential problem of a systemwide run. So, one of the things that I would like to see introduced, and I think would be introduced by a private guarantee system—not one private insurer but several, is increased diversity among the institutions.

Chairman ST GERMAIN. Ms. England, let me point this out to you. When there is a perception of a failure, as I discussed with Professor Kaufman earlier, there was that perception of Continental, then we had the S&L situation in Maryland. Then we had the situation in the State of Ohio which got news for you.

If you check with the FDIC, all kinds of private institutions that were insured have applied for Federal insurance. The building and loans associations of Massachusetts have all applied. Credit unions throughout the country are now applying for NCUA insurance and they are getting out of the State-blessed private insuring funds.

So you know, with all due deference to what you are saying, these are the problems that I find.

Ms. ENGLAND. That is a definite problem with the system as it is today. People in Europe don't understand the difference between a problem in Ohio and a failure of the whole system, a limited problem in Ohio where all of the ODGF——

Chairman ST GERMAIN. People in the United States didn't understand it either. You don't have to go to Europe. You can stay right here.

Ms. ENGLAND. OK. We will stay in the United States then, but that creates a weakness within the system. And creating an environment that allows institutions to differ and to sell those differences to the public would help to overcome that perception that when there is a problem with one S&L in Ohio, there is a problem with the whole system of savings and loans.

So one of the reasons I suggest a system where banks and savings and loans can choose different levels of deposit insurance is so that they have to then go out and sell that we are a single, individual, distinct institution. I agree with you that is a very severe problem we face right now.

Chairman ST GERMAIN. Ms. England, it was like the Vietnam war in its impact. It is going to take many years for that to dissipate and I am afraid that the impact of the Maryland and Ohio incidents is going to last for quite a period of time.

And my time expired a long time ago.

Mr. Wylie.

Mr. WYLIE. Thank you very much, Mr. Chairman.

I can testify that people in Europe do not discern the difference between thrifts and State charter banks and banks across the United States. I happened to be there at the IDB meeting in

Vienna at the time and talked to the editor of the Financial Times and I said: "71 S&L closings in Ohio couldn't have any impact on the decline of the dollar, could it?" He said, it did because the headlines over here were "71 Banks Close in the United States."

So there is a matter of perception here that we have to help identify and I suggest that the chairman is correct that we do need to help the press in this identification process and maybe people across the country as well.

The chairman did identify two other problems in two other areas which are of concern to me. One, the market value accounting approach to helping solve this problem that we now face and my own Professor Kane—I say "my own Professor Kane" because he is a constituent of mine, and frequently communicates with me about matters of banking—has suggested the market value accounting approach in his testimony and his book which just recently was published.

I had some problem with him identifying some of the areas here where we would have difficulty, it seems to me.

Professor Kaufman, maybe I will ask you first. You advocate the market value accounting approach. How would you value such things as commercial loans or mortgages?

It is easy to identify a piece of real estate. You did it in the case of Bank America, or mortgage servicing rights, or good will.

Mr. **Kaufman**. Yes, sir. Let me answer that as follows. Commercial loans and mortgages are more and more—both of the types of loans you mentioned—becoming what is known in the street as "securitized"—a horrible word, but no worse than "prioritized," I guess—which means that similar securities are being sold on the market.

They are being broken up, like a mortgage-related security. There is a security sold on the market that is collateralized by the commercial loan or by the mortgage. Almost all mortgages now have market values.

I think that you have chosen two assets that are reasonably simple, except tailored loans, to value. There are many others. Good will is almost impossible to value. I argue, when I talk to bankers on this, I say market value accounting is not easy but if you are a loan officer, what do you do? How do you evaluate the firm, or the individual, or the stock against which you lend?

I know I periodically buy stock on margin and the loan officer looks at the value of the stock at the time I buy it. And when that stock falls in value he calls me up and says, "either decrease the value of the loan or we have to sell you out." I say, "how about using book value? I bought that stock at 60. The fact that it is 40 now should not matter. After all, you keep your books on book value." He says, "that is the rest of the bank. I don't operate that way." And I think that is it. Bank loan officers do a reasonably good job. They have to.

In some cases they fail to do it with consequences that we have seen. They do make the best estimate of the market value because that is the value of the collateral that underlies the loans.

So it is not easy, sir, but we are moving rapidly toward it and the computerization of banks and the securitization of assets is making it a lot easier than it was just a few years ago.

Mr. Wylie. Wouldn't this be an added nightmare for the supervising agency?

Mr. Kaufman. Not really. We do have on the security side market values that are in the public domain. We have auditing firms and, while I agree that auditing firms, public auditors in the past have performed not as well as we had hoped they would, with public pressure on them they may do better. They do this regularly.

This is a regular procedure that the banks follow, that the public auditors do, that the insurance agency also can train its examiners to undertake.

Mr. Wylie. Professor Pyle, I guess you were the one that mentioned the Bank of America's real estate thing. Would you like to comment on my question, please?

Mr. Pyle. I would support most of what George has said, but I would go a little further and that is that we have a lot of financial institutions in this country where we have market values. They are quoted every day. Stock price of Bank of America, Bankers Trust, Morgan Bank is quoted every day. The values of their preferred stock are quoted every day.

Those are marvelous tools for our regulators to use that, in fact, don't require a great deal of examiner time and cost to come up with estimates. Now, obviously, as Ms. England suggested, you can't do this across all institutions because all of them aren't publically traded. We don't have reliable numbers, but we can do it for a large bulk of the deposits that are covered in this country and that would be a very favorable step forward.

So I generally agree with the suggestion that changes in the markets, the increase in securitization, as we say, of these instruments is increasing the possibliity of doing this, but I would also argue that looking at market values of the securities issued by these institutions is a great signal.

I can tell you, for example, Mr. Wylie, in the Continental circumstance, and I am sure you know it, too, that when the Penn Square scandal emerged, the value of Continental Illinois fell like a stone.

If they were soundly capitalized before that event they surely weren't soundly capitalized after that event. My argument is that is when something has to be done. That is we have to go into those institutions that we see. We are not going to outguess events. We can't. There is randomness in the world.

Things are going to happen that we can't anticipate. Penn Square type things are going to come along, but when we see that they have happened, I say rather than continue to pretend that the book value of Continental Illinois had anything to do with the coverage of deposits, we should in fact at that point face up to the facts of the situation and ask for recapitalization.

I can also tell you that long before deposits started—noticeably started leaving Continental Illinois in May 1984, long before that, by February their stock price was indicating that the market thought there were lots of problems in that institution. Again, a time to intervene, a time to do something, if we don't use these outmoded, outdated, inaccurate book value standards.

Mr. Wylie. Thank you.

Professor Kane also recommended that kind of a mix of private insurance, Ms. England, and FSLIC or federally insured insurance. I have the additional feeling that private insurance is an idea whose time has expired, but I am willing to listen.

First, how would depositors effectively assess the relative quality of insurance as a safeguard?

Ms. ENGLAND. Of private insurance as a safeguard?

Mr. WYLIE. Of private insurance.

Ms. ENGLAND. I suspect if we had a more widely spread system, we would see ranking services, bank rating services or insurance fund rating services that would provide information to depositors and news to people as far as which insurance funds were the best capitalized and were providing the best oversight.

I also think another lesson that came out of Maryland and Ohio is that institutions who choose to use private insurance, either as a supplement or as their whole insurance fund would become a lot more careful about who they got their insurance from because it became apparent that it was not good enough to have a well-run institution yourself if your insurance fund was not sound.

Mr. WYLIE. What is to prevent collusion between an insurer and an insured institution or that thought in the mind of the depositor and why would I as a depositor want to put my money in a private insured institution when I can get the full faith and credit of the Government behind my deposit?

Ms. ENGLAND. I would suggest probably the reason you would want to do it—if the institutions offer the same services, you should obviously go with the full faith and credit of the Federal Government. The reason you would choose a privately insured institution is because it could offer you a wider range of services either geographically or through offering additional financial products.

As for the question of how closely the insurer and the insured worked together, they should work closely together, but if we are talking about truly capitalized private insurance funds that can't rely on a Government bailout, it is in the interest of those insurance funds to monitor and control the behavior of bank managers.

The very survival of private guarantors depends on monitoring and controlling the behavior of the institutions they insure.

Mr. WYLIE. So they would have to have extensive auditing and management staff?

Ms. ENGLAND. Absolutely. The first question I would ask if I were considering a privately insured institution is does it have the power to audit, does it have the power to in the extreme case to remove managers without waiting for Federal or State authorities to do so.

I would, before I would choose a private insurer, insist they have those powers.

Mr. WYLIE. Thank you.

Thank you, Mr. Chairman.

Chairman ST GERMAIN. Professor Kareken, last year in hearings we discussed some rather extensive surveys that were taken by one of the biggest magazines in the country. The results showed that—with regard to diversity of services, that is, one-stop banking, that although it is great in the eyes of the press and, with all due deference, theorists and academicians, the general public is not at all excited about one-stop banking.

It is not the case. My staff can probably find the survey for us but it has not been proven. It is not something that everybody has been waiting for or looking forward to, you see.

Mr. **Wylie**. Will the chairman yield on that point?

Chairman **St Germain**. Sure.

Mr. **Wylie**. Except for the fact that the brokers in my district are doing very, very well with their one-stop banking centers.

Chairman **St Germain**. There is an exception to every rule. I am just quoting the surveys.

Ms. **England**. May I make a very brief comment?

Chairman **St Germain**. Sure.

Ms. **England**. I don't expect we would have super-mega nationwide financial institutions that offered one-stop shopping. I think we would have some that offered one-stop shopping to customers to whom that was important and we would have a lot of other specialized——

Chairman **St Germain**. But you see the point you were making or one of the points you were making was that the privately insured institution can offer a diversity of services and that is why people would go to that institution.

Well, you know, I think if there is a question as to whether their deposits are truly and really insured as against having the convenience of one-stop shopping, that they would rather go make a couple of stops and know that their institution is insured backed by the full faith and credit of this country.

Ms. **England**. I fully agree. You have to have market disciplines to allow an institution to offer a wider range of services. The more diversified depositories would definitely have to come up with a means to assure depositors their deposits were safe, not necessarily insured, but safe.

Chairman **St Germain**. You could open a bank tomorrow and offer all kinds of services. Nothing stops you from doing that except for the fact that you don't have insurance; right?

Ms. **England**. Right.

Chairman **St Germain**. That is why you wouldn't be very successful unless they thought Ms. England was the most brilliant investor in the world and could never go wrong or whomever it might be.

My time is way beyond.

Mr. Schumer.

Mr. **Schumer**. I have no questions, Mr. Chairman. I thought I would surprise everybody.

Chairman **St Germain**. Mr. McKinney?

Mr. **McKinney**. Thank you.

Ms. England, I am afraid I have to agree with my good friend from Ohio that private insurance's time has expired. But in wandering through—leaving my good friend's home State alone—the Maryland thicket, I amazing enough, found myself feeling sorry for the president of Old Court. Mr. Chairman, they limited him to $1,000 a week income today.

He says it takes $4,000 a week to live. That is more than we get paid after taxes in a month. The thing that is so fascinating is there was no responsibility factor. In fact, the State insured institutions were just using the cheaper premiums which meant the insurance fund was valueless. It's incredible to see the risks they took to be able to pay a little bit higher yield and be more competitive in the market. Therefore, the insurance fund was, in fact, sowing the seeds of destruction.

I would like to move on to a general point, Mr. Pyle, I have said some very nasty things about the savings and loan institutions in California and market value. Could the banking system today, could the thrift system today stand the shock of going direct to market value? I don't want to throw stones at Chase or Citibank or anyone else, but I look at their assets and I see a $50 million debt to Argentina. Now if you and I took $100,000 worth of Argentina bonds down to the bank and asked to use them as collateral, they would probably give us $3,000.

Could the system stand that shock of going to real market or proven market value?

Mr. PYLE. The answer, I think, is no. The system can't stand it today, but in 1960 maybe it couldn't stand it. We didn't do anything about it between 1960 and 1965 in the thrift industry in particular and we didn't improve the problem today.

The problem is worse today as far as I can see. So my point is maybe you can. Maybe we can't invoke this immediately. Maybe we can't invoke market value closure rules now, but isn't it a time to decide that this is a principle that we want to move to, that we want a process to go on here that will evolve to that, that will result in that at some date in the future?

For example, the Congress looked at deposit interest rate ceilings and said at one point this can't be done today. It is too hard on the institutions. But we will set a rule. We will say that at some point in the future, 6 years from now, I believe, the number was, we are going to have this phased out.

Well, I am saying that is an option that is open in this policy decision, not to try to face up to the question necessarily can we do it today, but should we do this and should we start a process that will lead to that result eventually.

Mr. MCKINNEY. Have you got a year in your mind? How many years?

Mr. PYLE. My personal opinion is 5 years ought to be enough, but I haven't studied it well enough to know that is enough. But if the institutions—I certainly don't want to restrict the problem to thrifts any place or thrifts in California, particularly.

There are lots of institutions in this country that if you ask them to face that test today they wouldn't be able to do it. On the other hand we have a process that is going on that I think is favorable and desirable in which we are asking institutions to increase their capital.

I think that is a desirable thing. The problem I find with it is that we are still basing it on book value. We are telling them, OK, increase your capital. Well, they increase it today but what I know and what you know is that as any of those institutions, for whatever reasons the future may bring, begins to get into trouble that book value will deviate from market value and it will deviate in one direction.

The book value will stay up and the market value will go down.

Mr. McKinney. Mr. Kaufman has been anxious to add to that.

Mr. Kaufman. Yes, sir, banks and savings and loan associations borrow money and then they have to repay it at maturity at par value. Market value gives you the estimate of what they can sell their assets for. If the market value of the assets are less than the value of the deposits they cannot repay the deposits in full and on time.

Subsequently, the question comes up, especially with the S&L's today, who takes the hit? Is it the taxpayer? I think it is fully understood that the only reason people put funds into savings and loan associations today is because of the guarantee of the Federal Government; there are no uninsured depositors?

I would much rather have the hit—the loss is there—suffered by the uninsured depositor than by the taxpayer. There is a tremendous burden on the taxpayer.

Mr. Barnard. Would the gentleman yield?

Mr. McKinney. Yes; my time is up. I think the chairman is being a little forbearing today.

Chairman St Germain. Go ahead.

Mr. Barnard. I hate to bring this up at this time, but it keeps coming up and I would even ask the distinguished staff to assist me in this. We talk about the taxpayers' loss. We talk about a loss to the Federal Government.

You know, according to my knowledge and information, there is no law on the books where the U.S. Government full faith and credit stands behind the insurance funds so how do you say, Dr. Kaufman, that the taxpayers and the Federal Government stands behind it?

I know that in 1982 we passed a concurrent resolution whereby the full faith and credit stood behind the FSLIC.

Again, if my limited knowledge is accurate, that phased out at the end of that Congress, so how do we keep on talking about the fact that the Federal Government stands behind it?

Mr. Kaufman. You are perfectly right, sir. But it is the perception of the public fostered by the savings and loan industry. On television today and in the newspapers there are full page ads sponsored by the U.S. Savings League saying it is a full faith and credit guarantee of the U.S. Government.

I have questioned the League. I have told them the point you have made, that the 1982 resolution does not bind subsequent Congresses as to what they are going to do. But with public pressure there is no way, although I stand in respect of Congress that Congress will not come to the rescue of the insurance agency.

Mr. McKinney. I would like to regain my time for a moment to make a point. There have been times when banks have paid increased premiums and bank fees for risky investments. Mr. Kaufman, surely if the uninsured depositors should take the beating, so should the bond holders and the stockholders of the institution, yet at Continental Illinois, we found bearer bonds, we didn't know where they were. And those guys sort of rolled merrily along.

I would love any of your comments at a future date if you feel so inclined as to let me know how soon you think we could go to market value.

Mr. Pyle, my time has expired but I am very interested in your feelings on the Federal Government's responsibility of insuring California S&L's which have been empowered by the California State Legislature to make risky loans and very questionable investments. I guess I am particularly worried because we learned yesterday that the State of California evidently only has 68 regulators and examiners for the thrift system in the entire State of California.

Thank you.

Mr. **Kareken**. Mr. Chairman, if I might just respond very briefly to Mr. Barnard. There are other ways in which the taxpayers can——

Chairman **St Germain**. Professor Kareken, with all due respect, I am going to respond to Mr. Barnard.

As a practical matter, if one of the funds were to be depleted, we would have a crisis, and as a result, therefore, we would have to and would move so fast, so fast it would be like lightening.

Full faith and credit would be available. We know that.

Ms. Oakar.

Ms. **Oakar**. Mr. Chairman, I just want to make one quick statement because my colleague from Ohio has some questions as well, Ms. England, I respect your credentials and if, several years ago, you had come up with your plan, I probably would be very attracted to it, but I am from Ohio and I must tell you that perception is very important.

There were some S&L's in Ohio that really and truly did not deserve a run in comparison to one of the institutions but it happened. As a result, my taxpayers from Ohio did, in fact, pick up the tab because the legislature passed a bill appropriating State funds; something they had to do.

They didn't have a choice. And so my people and Marcy Kaptur's and others did pick up the tab for something that really was not directly related to them, particularly in northern Ohio.

That is why I think we are playing a psychological game. The fact is the American people have more confidence in a Federal national insurance program than they do anything else. For that reason I introduced a bill that requires that S&L's have to have Federal insurance. I don't want to see a run in another State. Every day I read about Maryland's situation. I don't want to see that happen again.

I think we are dealing with a very mercurial situation. Perception in the banking industry is extraordinarily important and I don't think at this point in time your plan is something that we ought to consider. With all due respect to the creativity involved, the uniqueness, and the substance of it. I honestly don't think it is the right thing to do at this point in time.

Thank you, Mr. Chairman.

Ms. **England**. Might I just respond briefly?

I think one of the important things that should come out of Ohio and Maryland is a great deal more skepticism on the part of the public. They looked at Ohio Deposit Guarantee Fund and Maryland Savings and Share Insurance Corp., and they assumed that they were backed by the State. They didn't really pay attention to, I don't think, the stability of the particular funds or how they were run. The public should be skeptical.

Ms. **Oakar**. Surely you are not suggesting that the public should be, or should view the entire industry skeptically. One of the problems we have in our country, in my judgment, is that people do not save as much as they did in the past. We don't have the kind of savings rates as other countries and maybe that inter-relates with our trade deficit.

I would not want to suggest that people ought to be skeptical about the banking industry in general. I think they ought to have more confidence because we are having these hearings.

Ms. **England**. Not skeptical about the banking industry, skeptical about non-Federal insurers. If a non-Federal insurer, insurance fund can survive when people have been frightened.

Ms. **Oakar**. In my State it didn't survive. One savings bank.

Ms. **England**. There is a private credit union insurer in your State, National Deposit Guarantee.

Ms. **Oakar**. That is somewhat different. I am talking about the issue of the S&L. One savings bank and some fairly large S&L's depleted the entire fund. Percentagewise, our S&L's that were into that fund contributed fairly generously and it was not even enough.

Then it caused this problem which I think was addressed expeditiously. We don't have a crisis now in Ohio, but there are some problems in Maryland, for example. I think other States are starting to look at that whole psychology and phasing out their non-insured funds.

I feel very strongly now. I feel so strongly I have introduced legislation. We ought to do something to restore the faith and mandate that these institutions be under the same regulation as other institutions.

I guess I am a convert to the chairman's philosophy there, but nonetheless, I really feel that way now and I might not have felt that way 2 years ago or a year ago if you had appeared before the committee.

Thank you.

Chairman **St Germain**. I know you didn't. With regard to the Maryland and Ohio incidents, you have to ask to yourself why, why were they not federally insured? Why didn't they seek Federal insurance? They have come up with a lot of reasons, but, in essence, what it boils down to, I think, is very clear. The manner in which they conducted their business was not up to the standards set by and required for federally insured institutions. This is borne out by the fact that so many of them are still waiting in line and have not been able to qualify for Federal insurance.

As far as I am concerned, I am not going to discuss private insurance any further because there are a lot of other items we should get to.

Marcy?

Ms. **Kaptur**. Thank you, Mr. Chairman.

As I consider this whole issue of deposit insurance reform, my mind does two things. One, it looks back at the history of financial institutions in our country and certainly at the recent history in

States like my own, Ohio, as well as what happened with Continental Illinois.

It also looks ahead and we had some witnesses last week who told us that one-third of the savings and loans are on the troubled list in this country and they were going to get us the number of commercial banks that were on the troubled list.

I think he said there were 261, but I could be wrong about that. They were going to go back and check the number. I asked myself in view of the way in which the Ohio situation and Continental Illinois was handled and in view of what is likely to happen in the future, what role does this deposit insurance reform really have in building confidence in the entire financial system? I have looked at each of your testimonies. Mr. Kareken, I came in late and didn't get yours, but I hope you will comment here.

What I am interested in, Mr. Pyle, as I read your testimony, is that you do not think the insurance issue is really all that important. You think something else is more fundamentally wrong with the system, If I read it correctly, you think the way in which we either regulate or supervise or something else should be changed before the insurance premium structure. You think that should not look upon the insurance issue as the central one, as perhaps some of us on this committee might have been.

Ms. England, you would like to redesign the system to move more toward a privatized system. It is hard for me to imagine what that might be like but I think we used about a $100 million of taxpayers' money in the State of Ohio and had to lure in some outside banks in order to settle that situation.

I don't agree with what was done, but I saw what happened in my own State. I don't know how comfortable I feel about your policy focus to move us on the insurance route, but to do it more on the private side.

Mr. Kareken, I can't really say I heard your testimony, but I guess I would like each of you, starting with Mr. Pyle, to comment on what I have just said and whether or not our focus on insurance is the appropriate one in view of the recent history and what is likely to come down the road.

Mr. **Pyle**. I think the focus, as I said at the start of my talk, I think that the focus on insurance is proper. I think that is the system we have. We have a system of guarantees of people's savings and transactions deposits. So focusing on that system and reform of that system is what I addressed, however, I said that there are lots of ways to reform the system and sort of getting hung up on particular ways to do that, for example, risk adjusted premiums or risk adjusted capital or, for example, the existing system, in a sense misses the point.

The point I tried to make is that under any of those systems there is, I believe, a fundamental requirement that we move to a market value rule for closing the institutions.

If we don't do that——

Ms. **Kaptur**. Take the Continental Illinois situation. What would have——

Mr. **Pyle**. As I suggested earlier in my comments, in the Continental situation when Penn Square failed, Continental's market value fell like a stone. You can go to the stock price and you can see what happened.

Ms. KAPTUR. Where in the regulatory sytem should somebody have been paying attention to that?

Mr. PYLE. At that point under the argument that I am making, the FDIC or whoever else, or the comptroller—you know, I guess what we may be debating here a little bit is who ought to have that responsibility. Currently it is the comptroller and the comptroller in my view, should have gone to that institution and said it is time to recapitalize. We know, the market is telling us that you are not worth what you were 2 days ago. It would have been great if we had known that before.

We didn't, but we know it now. Let's do something. And if we would go on beyond that, if you go to the full failure of Continental Illinois, I will argue and could show statistical evidence to support this, that the market, the stock market in Continental Illinois gave a statistically reliable signal that that institution was in trouble by February of that year.

Now, as far as I know, nobody went into that institution and said you are either going to recapitalize—we think your market value is not meeting the test. The test is could you pay off all those deposits that are being guaranteed in this institution, and I point out that what we ended up doing, and we have ended up doing in every large failure except Penn Square, is insuring everybody so at that point we have to address the issue will your assets cover those claims.

I submit the answer would have been no and I submit that Continental Illinois should have been faced with the question of closure then or recapitalization. If we had done that, we might have avoided some of the losses to the Federal Government or to the insurance funds that occurred as smart people read these signals and got out of those institutions.

Ms. KAPTUR. Why do you think they didn't do it? Because they weren't required to?

Mr. PYLE. As far as I know, they are legally not permitted to make a closure rule on the basis of market value today. The closure rule as far as I know that they are legally permitted to use is one that is based on book value.

I just think that is completely an outdated proposition in the kind of economy, in the kind of circumstances that our financial institutions are in. If you have a nice stable world in which book values and market values track each other over long periods of time, that is a perfectly sound solvency rule.

If you have a volatile world in which book values and market values don't track, it becomes an irrational and a dangerous rule.

Ms. KAPTUR. Mr. Kaufman?

Mr. KAUFMAN. Deposit insurance has only been around since 1934. Banking has been around this country for a long, long time and banks worked reasonably well, so it is instructive to go back and see what happened prior to the introduction of the FDIC.

We had 10,000 banks by 1890, about 20,000 by 1910 and 30,000 by 1920. In the years from the end of the Civil War, which preceeds me by a few years, to 1919, we only had 1 year in which there were more than 200 bank failures and only 9 years in which there were more than 100 bank failures, all without deposit insurance.

The greatest crisis, of course, was 1929-1933, after the introduction of the Federal Reserve System which was intended to prevent failures.

How did the banks handle this situation? One, depositors could not rely on the insurance funds so they had to make some estimate of market value. They had to make some estimate of were they going to be paid back. This kept bankers on their toes.

They didn't then make the kind of loans and kind of investments that they would otherwise or that they would today. The depositors looked over their shoulders and as soon as they thought that the bank would not be able to repay them, they withdrew deposits from that bank, but not from the banking system. It was deposits going from bank A to bank B.

It was a game of musical chairs. So this served as market discipline to make the managers and owners of the bank fearful. Owners carried a great deal of weight because not only were capital ratios much higher than there are today—they were about 30 percent of assets—but for national banks the owners were liable for double the amount of their investment. This means that the shareholders paid a great deal of attention as to how bank management loaned its funds.

So deposit insurance, while I favor it and I think in today's environment it is necessary to prevent a drain of currency from the system as a whole, has permitted bankers to be more sleepy, to take greater chances and to engage in the kind of activities that we observe. We have risk incentives that are encouraged by deposit insurance.

Chairman ST GERMAIN. Mr. Barnard?

Mr. BARNARD. Thank you, Mr. Chairman.

First of all, I want to commend all four of you on splendid testimony, and I think that each of you added something very significant to this discussion of what I think is a very, very important issue.

I think that Ms. England's testimony was academically sound, maybe critically not sound, but certainly something that we need to think about as we further consider this subject, and hopefully Congress will do something about it.

I guess my question is more of a comment than it is anything else, but we have seen steps put in place since the deregulation of interest rates which has, you know, really changed the whole spectrum of banking and finance in this country.

I don't know that we knew we were going to change it like it did, but we did. We changed it because we knew if we didn't change it, the marketplace was going to extremely cripple banks and savings and loans, because you very well know, we had a drain on bank deposits to the degree that it was unreasonable, and when we did finally take that step on deregulating interest rates, there was a turn-around, and our banks and our savings and loans have been able to recapture what they lost.

I think that, first of all, we will always need—in order to maintain a sound banking system in this country, which we have got to have, for transfer payments for no other reasons, we will always need Federal deposit insurance. I think that is a fundamental given.

But then, from that point on, as banks and savings and loans want to enter into the free market system, the free enterprise system, then there has got to be a given they cannot have all of these guarantees and go and continue to go in the area of uncontrolled investments.

Yet, I know that the banking industry is very much concerned about wanting to address all elements of the financial marketplace today. Some are real needs that the financial institutions need. Some are maybe just beyond that.

But I can see us needing to move to a point in time where there are certain investments that a bank will make whereby we will pretty well guarantee that the depositors are fail-safe, but then from that point on, where banks need to provide the services that are in the financial marketplace, then they can't have that protection.

See, I think that is what we are grappling at. How do we let the banks compete in the financial marketplace today, the complete financial marketplace as American Express, Merrill Lynch, Sears, but at the same time protect the banking system from its—really—with deposit insurance?

This is where I think there is a lot of compromise that has got to take place between the bankers, and us in Congress, and the general public. The general public is going to be a very important ingredient in this, because they can't just look at a bank door and see the word "insured" and walk in, and think that they have got 100-percent insured.

I think they are coming to that, but it took the climate in Ohio and Maryland to bring that to pass. I mean, if any of you care to respond to that, but that is how—we don't have an answer to this thing.

Nobody does, but we need to be moving toward this consideration. We need to be setting up this criteria, what we want, how we want to protect the public, and then from that standpoint, if financial institutions want to compete, they have got to take the risk.

Mr. **Kareken**. Well, if I might, that was precisely the rationale for my proposal, namely that the Government has this really classical responsibility. It is the same kind of responsibility that it has for law and order, the classical responsibility of preventing widespread disruption of payments and a breakdown, therefore, of the economic process.

So, you have to protect transactions deposits, but instead of getting into all of the technical difficulties of, for example, market value accounting, for which I have great sympathy, or risk-related premiums, for which I also have great sympathy, the simple way to do that is to require 100-percent backing of transactions account balances with Treasury securities at market value.

That part of a bank providing payments services is entirely separated from the rest of the bank which can then do anything it wants, but subject to the condition that none of the other liabilities are insured, so that if it wants to do investment banking, fine.

To the extent that it holds assets from doing that, that is fine. It has got to fund them on its own, without a Federal guarantee, and the split between the payment services part of a bank, and all the other services, splitting that really imposes no cost and what commends it—I don't often agree with Professor Friedman, but I certainly do on this point—what commends it is its simplicity.

It is a very straightforward approach. All you have to do is make sure, which you can do with computers, and the kind of communication system we have now, make sure that every bank is backing its transactions deposits 100 percent by Treasury securities valued at their market prices, and the rest of banking then doesn't have to be any of the Government's business.

Mr. **Barnard**. My time really has expired, but I didn't get but one response. Ms. England, could you and Dr. Kaufman and Dr. Pyle briefly respond to that?

Ms. **England**. I agree with the way you outlined the problem, and I am trying to address that, too. Bankers cannot expect to be allowed to exercise a lot of new powers and still have deposit guarantees to back them up.

That is why I am suggesting that bankers have more options rather than just you are insured or not insured, to be able to insure smaller accounts and have broader powers.

Mr. **Kaufman**. I think the problem is somewhat different. I agree with you, we need deposit insurance. But additional activities may not increase the risk to the bank, because the risk to the bank is not that of each individual activity, but of the combined pool of all activities. It is certainly possible for one activity that is risky to move, in terms of earnings, exactly the inverse of other activities. That would minimize the risk for the institution as a whole.

The problem comes with our premium structure and our penalty system. Re the premium structure, there is no greater penalty for taking a risk or making a riskier loan or not. All the encouragement is to make that risky loan.

Every Monday, my hometown newspaper, the Chicago Tribune, publishes a list of the federally insured savings and loans and commercial banks that file the highest interest rates on certain kinds of deposits.

Some pay 300 basis points higher than the average. You and I know what the institutions do with those funds. It has nothing to do with normal business activities. We don't care. We don't have to, because the Federal Government, legally or not, depending on the 1982 resolution, will pick up the tab.

So, I think we need to increase the penalty on these people to prevent them from taking the risk and not making that as profitable as it is currently.

Mr. **Pyle**. Well, I would just like to respond to the idea that Professor Karaken has made to you of splitting off transaction balances, and having some kind of 100-percent reserve banking.

This is an idea that goes back to the economic theory, the University of Chicago theory of banking from a long time ago.

Mr. **Barnard**. Is that what Continental practiced? I shouldn't have said that. Excuse me.

Mr. **Pyle**. A different part of Chicago. This was the South Side. That obviously is a way to solve the problem that George is talking about, that George Kaufman is talking about. It is one solution.

One solution is you don't have to charge anybody any serious deposit premiums if there is no risk imposed upon the system, so one way to bring the system back into balance is to make the assets, the assets and leverage of the bank, conform to the deposit insurance premium, which then can be rather small, maybe almost zero.

The question that——

Chairman **St Germain**. Excuse me. He said no insurance so far on that bank; therefore, why would I deposit in that bank?

Mr. **Pyle**. Because if his policy is carried out in terms of these balances, your deposit is completely backed and monitored by someone, the Federal Government, to make sure it is backed by Treasury securities of known value.

Chairman **St Germain**. Wait a minute.

If I deposit $100,000 and you have got to back it totally by Treasury securities, what have you got to lend to Professor Kaufman?

Mr. **Pyle**. In that system, you have nothing to lend to Professor Kaufman or anybody else.

Chairman **St Germain**. Where do they borrow it?

Mr. **Pyle**. They borrow it from the other part of his bank, the other assets. He is splitting apart these two things.

Chairman **St Germain**. What is a transaction account bank?

Mr. **Pyle**. A transaction account bank is one that only offers transaction services and has as assets only Government securities.

Chairman **St Germain**. Now, we go to the other bank. That is the one where Ms. England wants to manufacture widgets. She goes there to borrow the money to set up the widget factory, right?

Mr. **Pyle**. Right.

Chairman **St Germain**. That is uninsured. Those deposits are uninsured.

Mr. **Pyle**. You know, you are asking me and it is his——

Chairman **St Germain**. Professor Kareken, those deposits are uninsured; right?

Mr. **Kareken**. They may or may not be deposits, but they are uninsured.

Chairman **St Germain**. Where does the money come from?

Mr. **Kareken**. Well, they might be CD's. They might be just subordinated—

Chairman **St Germain**. Isn't a CD a deposit?

Mr. **Kareken**. That is a matter of law, but they can be funded anyway the bank wants to fund them.

Chairman **St Germain**. Not the Government, because if it is entirely uninsured, the Government does not regulate. The regulators don't come in. There is no examination.

Mr. **Kareken**. Precisely.

Chairman **St Germain**. Why would Professor Pyle, a brilliant gentleman, want to put his money into a CD in your non-transaction account bank that is uninsured?

Mr. **Kareken**. Because he would get enough of a risk premium to want that investment, depending on his appraisal.

Chairman **St Germain**. Enough of a risk? What do you mean by that? Rather than get 10-percent interest, he would get 12 percent?

Mr. **Kareken**. Yes.

Chairman **St Germain**. And that is worth taking that chance?

Mr. **Kareken**. Well, if Professor Pyle makes the investment, I would say in his mind, yes.

Mr. **Barnard**. Mr. Chairman, it is done every day with these high-yield bonds. I mean, the marketplace—they determined that that is what they want.

Chairman **St Germain**. Those are high-yield bonds with definite collateralization. Isn't that a fact?

Mr. **Barnard**. Some of them aren't.

Chairman **St Germain**. I think they are.

Mr. **Barnard**. Some of them are just financial statements.

Chairman **St Germain**. Professor Pyle?

Mr. **Pyle**. May I just finish? I had not quite finished my comment on this. The point I got to was that you could do this. In some sense, you can solve this problem by splitting the bank apart, taking the lending function someplace else, and leaving the transactions fully backed.

The question, I think, has not been addressed here. Professor Kareken has one answer, and I don't know what the answer is—do you lose some economies of scope in that process?

Is there something about having lending operations and transaction operations in the same institution that is an important characteristic of banking. I think if you look at the history of banking, that is the way banking has, to my knowledge, always been.

That is no matter what kind of regulatory structure was set up, no matter what kind of guarantees were being offered, it has been the case that lending and transactions operations have been housed in the same institution.

Now, I can't give Professor Karaken a theoretical or a good model or anything that will identify why that is true. That is a conundrum that financial theory has been working on at least since 1900, and I don't know of anybody who solved it yet, but I have in my own mind a lingering suspicion that this economy of scope question is an important one, and, therefore, that particular solution to the problem has to be faced with a question, yes, it does remove some costs, yes, it does make for a system of guarantees that is reliable. Does it cost us someplace else in terms of the economies of scope in operating financial institutions?

Chairman **St Germain**. Professor Kaufman, if Citicorp were to convert itself into a Kareken-Golembe Bank, that just lends and is uninsured, that would be a rather large institution, would it not? They would have loans out and loan commitments, and probably the Professor Pyle type, who invested in that Citicorp bank would have a lot of money there. There might be other banks who might have put money in there as well, right?

Do you follow that theory?

Mr. **Kaufman**. Yes.

Chairman **St Germain**. Let's say the Kareken-Golembe Corp. is now about to fail. The Fed will look the other way and pretend it is not happening, right? All those banks that might be insured will take their lumps and the cities and towns that put their tax moneys in there for 6 months or 90 days will lose those moneys.

It is another Continental, isn't it? I mean, the same reasoning used in Continental for saving at all costs, using the most unusual reasoning to come up with the fact they had the authority to do what they were doing could be—would have been utilized there as well, wouldn't it?

Mr. **Kaufman**. Would not have to be, but it could, and I suspect——

Chairman **St Germain**. It probably would.

Mr. **Kaufman**. Probably. What Professor Kareken is recommending is that part of the bank be effectively transformed into a money market fund. We have these money market funds now. Anybody who puts their funds in that part of the bank does so as a transactions deposit. The other part of the bank will do the lending you talked about. If that part of the bank gets into trouble, I suspect the Federal Reserve would come to its rescue. And that is not a good solution to the problem.

I just want to make one more statement on that, and that is if there are losses to that part of the bank, it is not as large as they said about the Continental. Everybody is not wiped out. You only lose the amount the assets fall. As far as I know, I work sometimes 1 day a week at the Federal Reserve Bank in Chicago, which is across the street from the Continental, it was not totaled. If you take out the foreign loans, I suspect the losses to Continental were 2 cents on the dollar.

Chairman **St Germain**. There has been some 10 cents on the dollar according to Dr. Kaufman, which I read. I enjoyed that article.

Gentlemen—and ladies, what has not been brought up here to date, and I am wondering about that—what are some of the causes—and I guess we should have included that in the letter of invitation of the problems or what is bringing about the problems we have and that we face, and which we potentially face?

I go back to San Diego, a fellow named C. Arnholt Smith. Bearing out what you said about the February date, when the stock of Continental started to go down, remember the SEC was publicly investing USMB of San Diego, but the Comptroller's Office—they don't talk to each other, these agencies.

They didn't talk to each other. And it took a long time before the right expert came in and finally blew the whistle. But one of the causes or one of the problems of USMB of San Diego was C. Arnholt Smith, who had two shifts of employees. A lot of people in the financial press world came up and said what a dedicated, hardworking, brilliant go-getter he was.

Why did he have two shifts? He didn't want one shift to know what the other one was doing. And why? The man was a wealthy man years before, but he had this greed, this passion for bigness. He wanted his institutions to be one of the biggest ever.

As one chap, who is no longer on the committee, told us, his wife was with one of the banks that sent these fellows in their banker suits and briefcases into the wilds of Africa to lend money to these emerging nations. They shoved loans down their throats, insisting they take that money because they had a lot of deposits, and figured they were going to get a little extra on interest. It was a good deal for them.

Penn Square, they wanted to grow fast. Continental of Illinois—why did they get into so much trouble? Remember "Forbes Magazine," and all of them writing up Continental Illinois? Fabulous growth. The competition between First Chicago and Continental, they were competing to see who was going to be the biggest.

Chase purchased some of those loans. They wanted to be big, but as a result of the bigness, we found—incidentally, you can dispute this one also—economies of scale stop at about $500 million is, I think, the general rule of thumb, is it not, as far as a bank is concerned?

Once you go beyond $500 million, the fact you are getting bigger and have more business does not mean that you are better and that you are more economical. So shouldn't we consider this passion so many of them have for getting to be the biggest and most highly recognized and to hit the headlines—and also, by the way, concomitantly to have increased salaries for the chief executive and the top personnel—shouldn't that be factored in here as one of the items we have to look at, at least recognize, even though we might not do anything about it?

Ms. **England**. Yes; greed is obviously a problem we always have to deal with. The question is who is in the best position to monitor that? Federal regulators with limited staffs haven't been able to stop it. Their hands are often tied because they are required to impose certain regulations, and they can't always stop things before they happen.

Even though they see problems developing, they cannot always stop them if regulations don't forbid that sort of behavior. I think private guarantors that wrote private contracts would have a better chance of saying we are not going to tolerate certain behavior, and we are going to cancel your insurance or liquidate your institutions.

But greed, yes, it is a problem.

Chairman **St Germain**. Professor Kareken?

Mr. **Kareken**. Well, I think the *San Diego* case is particularly interesting, and for precisely the reason you mentioned. That is why I believe that you can describe the supervisory-examination process as being unreliable, basically flawed. You can never stop a bank before it is in obvious trouble.

Continental was—at the very time it was getting into trouble—was still being hailed as the model bank, so the examination process is just too unreliable. As Professor Pyle said, there may be certain costs associated with what you call the Kareken-Golembe Bank, and what I call the Karaken Bank, but you don't have to rely on what has historically proven to be a very unreliable process; namely, the examination or audit process.

I have to agree with much of what you have said.

Chairman **St Germain**. Professor Kaufman?

Mr. **Kaufman**. I also agree with what you say about greed, and the drive for growth is not limited to the banking industry. We see it in other financial services areas.

Chairman **St Germain**. It is different in banking because of the exposure of the taxpayers.

Mr. **Kaufman**. This is the reason, and it is unique in banking because it is easy with deposit insurance. Anybody can grow overnight without people looking at their balance sheet. At least in other sectors where somebody tries to grow fast, there are stockholders and creditors who look over their shoulder.

We make mistakes; they make mistakes. Otherwise, we wouldn't have any firm go bankrupt. In banking there isn't even that constraint. So growth is much more dangerous with the present deposit insurance system.

Mr. **Pyle**. I really can't add anything to that, Mr. Chairman.

Mr. **Barnard**. I just want to comment on the second paragraph of Ms. England's testimony.

I don't guess time will permit us to get into it, but she says,

> History provides ample support for the conclusion heavily regulated industries become increasingly inflexible and myopic. Their attention is directed from the market to the political arena as each industry attempts to persuade political decision-makers to protect his turf gains short-term infringement buyers.
>
> Members of protecting industries almost invariably look to the Government as a source of their long-term survival rather than to their own creativity and ability to serve the public.

I can't see a thing wrong with that. I think she has hit the nail on the head. Yet, on the other hand, I see those in the industries trying to wedge out of it. I mean, we have to be honest. Banks want to get into other businesses because other businesses are in banking. And we see the savings and loans, for the purpose of earnings, for the purpose of building their capital, for the purpose of trying to hedge gains-losses from long-term investments and inflation and so forth. They are trying to get further into the banking business so maybe they are not as myopic as might appear.

Maybe they are seeking to get out of this box that they are in, but by getting out of the box, they are trying to get out of the box to earn more money. I know, they are being constrained by the Government. OK, am I wrong there?

Ms. **England**. No, I have no argument. I agree with you. I think that effort should take place in the market, though, rather than having the savings and loan people send their representatives here to say, "Well, we want to get into banking, but you can't let other people do this." And the bank says, "We want to get into investments, but you can't let the savings and loan people onto our turf."

It should be a market competition rather than a political competition. But development, in my writing the paragraph, I didn't want to say that all bankers are totally focused on what is happening in Washington and the State capitols. Certainly some are very interested in the competitive process and doing that and pushing forward the industries.

Chairman **St Germain**. Mr. Carper?

Mr. **Carper**. Thank you, Mr. Chairman.

I believe you said in your statement, Mr. Kaufman, the newspaper in Chicago lists the five banks or S&L's that offer the highest yields in any particular week——

Mr. **Kaufman**. Every Monday the Chicago Tribune does this. It comes from a national service, and there are a number of such services available in the country.

Mr. **Carper**. I believe your implication that grew out of that is even if we take action in limiting brokered deposits, those are likely to be of little impact.

Mr. **Kaufman**. Very much so.

Mr. **Carper**. What I would like to ask of the other panelists is, is there anybody who disagrees with that notion?

Mr. **Pyle**. I don't.

Mr. **Carper**. Mr. Kareken?

Mr. **Kareken**. I think you might have some small effect on the losses that are incurred by the insurance agencies if you were to take some sort of action to limit broker deposits, but the effect would not be long-lived because there are so many ways of brokering deposits that you would be forever chasing after the latest technological innovation. Today, in fact, you don't even need brokers to broker deposits. That can be done by a national screen service or something like that.

I think the agencies are right in saying that the way things are at the moment you are giving failed institutions one last gamble with brokered deposits, and thereby increasing exposure of the agencies, but I don't believe you are in a position to effect a solution. The marketplace will always outrun you.

Mr. **Carper**. Thank you.

On page 4 of your testimony, Mr. Kaufman, you have a statement here that says, "Old shareholders should be removed and management changed before they can throw Hail Mary passes at a last minute attempt to regain profitability." I like the idea of the Hail Mary concept. That is certainly one I will use, myself, in future speeches.

I would like to refer back to some earlier testimony we had before this subcommittee, and we heard from some people who were saying there should be greater flexibility on the part of regulators to be able to change management. They felt they did not have sufficient flexibility to make as quickly as they like a change in management, and they had to put up with management.

They deemed it as, if not corrupt, ill-advised. I would be interested in your impressions as well as the other witnesses as to what actions, if any, the Congress should undertake to provide greater flexibility in changing management.

Mr. **Kaufman**. I think Congress has given increased powers in recent years under cease and desist powers. The most powerful thing I think Congress can do is enact or encourage the recommendations I think all of us have made and that is market value accounting. Also, that when a bank cannot pay back its depositers, it is effectively put out of business. It either is sold, which means it is recapitalized, it is merged, or it is liquidated.

I do not want to give the regulatory agencies arbitrary power as to when to throw out management. That sounds fine, but if the wrong regulator gets in, that causes problems. That is why we have a democratic system of checks and balances. But the inability to pay back creditors is an objective point. When a nonfinancial firm, an uninsured firm, gets into trouble, and the creditor doesn't think he gets paid back, he goes to court and forces bankruptcy.

I sit on a board of trustees of an institution that used to be smaller than the Continental. Now it is larger—the Teachers Insurance and Annuity Association and College Retirement Equity Fund—$40 billion. We encouraged them to go to market value accounting and management said it was impossible. "We can't do it." We sat on them and sat on them, and now it is done regularly.

I know it is not precise, but I know it is closer to the true market value then book value. I think the power you can give to regulators is to throw out crooked, incompetent, and accidentally bad management—a lot of these failures are due to accidents—you and I—at least I know I make mistakes.

Mr. CARPER. I do, too.

Mr. KAUFMAN. We never want to physically close a bank. This didn't happen prior to 1930. We did not have Ohio's; we did not have Maryland's. We never had that crisis. To change management when it can no longer pay back depositors, that is a rule that I don't think can be misused.

Mr. CARPER. Anyone else care to comment on that point?

Mr. KAREKEN. I prefer my recommendation because I see that as a can of worms. It sounds very good—and I certainly have a lot of sympathy for market value accounting, and for an objective closure rule, although there is an important distinction that economies laugh at, but I think is real between liquidity and solvency.

You just don't want to give regulators—I just don't want to give regulators—that kind of authority. I prefer a scheme under which they don't need it.

Mr. CARPER. One last question dealing with market value accounting, Dr. Kaufman. You have indicated you think that is another idea whose time has come, to quote you. We had a witness before the subcommittee, I think, yesterday—was it Dr. Kane, I believe, from Ohio State—who pretty much sounded the same note.

What action if any is required by Congress to speed adoption of market value accounting?

Mr. KAUFMAN. I think most of it will lie with the regulators. What Congress can do—as Professor Pyle said, the regulations for closure now are stated in book value, which is historical cost value—is to change the closure regulations for banks to market value, and that would obviously encourage the banks to go to market value and would encourage the regulators to do so.

Mr. CARPER. Thank you very much. Mr. Pyle.

Mr. PYLE. Part of the point I made in my testimony is that it isn't market value accounting that really is the fundamental issue. That might be a nice by-product. The fundamental issue on what basis are you going to shut these institutions down in the sense that they are recapitalized, emerged, turned over to new stockholders and new management?

That, I think, is the issue. Market value accounting might follow from that. It might have some other benefits, but what I think Congress can do, and I should do, is begin to address that issue of moving the closure system in our insured depository institutions toward something that is more closely related to market value.

Mr. KAREKEN. We use it now, but ex post.

Mr. CARPER. Thank you, Mr. Chairman.

Chairman ST GERMAIN. This issue of closing down at the proper time also, there are some reasons—I don't think they have been cited here—but I go back to Sharpestown. The first time I participated in a hearing on a failure was at Sharpstown in Texas. The thing that annoyed me was the regulators knew for such a longer period of time that that particular financial institution was never going to survive.

I was disturbed because some small credit unions, in-plant credit unions in my district, had been conducted by some nefarious evil, nasty, uncouth, immoral, money brokers in Boston. And they gave the credit union officials, who were machinists, the impression that they were taking that $100,000 and going to get them a good return on it, and that it was fully insured.

Well, that money broker put that credit union's money into Sharpestown—of course, the rate was high because, as I said, the regulators knew that that institution was done for and just hadn't gotten around to doing what they should have done, so the credit union lost the difference between that which was insured at the time and the hundred thousand.

And that is when I get very irritated about waiting too long to shut it down—the public, not knowing, and many members of the public being enticed into going for those higher rates. It is a natural thing. And also that is when I become very disenarmored with money brokers, and therefore broker deposits.

I know that the testimony this morning wasn't too critical of broker deposits. Certainly they have a place, but I think that we have to make some changes. There has to be a little bit of change in the manner in which they are handled. It is not proper, I don't think, to use broker deposits, and for a large stockbrokerage firm to have a division of broker deposits, to make some healthy fees on this—although they maintain that they have looked into the stability of the institution involved the track record is very questionable here.

Furthermore, I don't see why the chairman of the Federal Home Loan Bank Board and the chairman of the FDIC would be as adamant as they are, as upset as they are, about broker funds. I don't think they would be that way without good reason.

There is no reason for them to complain about it unless they feel it is contributing to the problems that they face, and exacerbating the problems, so I won't ask for any comments, just give you my views on things, and the source from which they come.

It didn't happen yet, and today, but many years ago. I want to thank you very kindly, Ms. England, and gentlemen. We will have some written questions that the staff and I have prepared and other members as well will have some written questions.

We would like to have you answer them for the record. I am sorry Congressman Barnard left, because he came over to me a few seconds ago and he said, "I think we are going to have to resurrect Solomon to figure this one out." Really, it is getting tougher and tougher.

Now, if any one of you come up with some new ideas you feel we need, please, please don't be bashful. We need all the help we can get.

The subcommittee stands in recess until the call of the chair.

[Whereupon, at 12:20 p.m., the committee was adjourned, subject to the call of the chair.]

[Letters of invitation to the witnesses for this day follow:]

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TOBY ROTH, WISCONSIN

September 10, 1985

Ms. Catherine England
Senior Policy Analyst
The Cato Institute
224 Second Street, S.E.
Washington, D.C. 20003

Dear Ms. England:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on September 19, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

1. Modified Payoff
2. Subordinated Debt Capital
3. Risk-related Deposit Insurance Premiums
4. Risk-related Capital Requirements
5. Insurance Fund Recapitalization
6. Insurance Fund Merger
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8. Reduced Deposit Insurance Coverage
9. Greatly Instensified Supervision
10. Market Value Accounting
11. Private Deposit Insurance
12. Brokered Deposit Restrictions

In accordance with Committee Rules, please deliver 175 copies of your prepared statement to Room B303 Rayburn House Office Building twenty-four hours in advance of your scheduled appearance. Your statement in its entirety will be included in the hearing record, and if delivered when requested, the statement will be made available to all Subcommittee Members in advance of the hearing. To provide all Subcommittee Members with sufficient time for questioning, the oral presentation of your prepared statement must be limited to ten minutes.

Sincerely,

F J St Germain

Fernand J. St Germain
Chairman

FJStG:dDv

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TOBY ROTH, WISCONSIN

September 10, 1985

Dr. John Karaken
Professor of Banking
School of Management
University of Minnesota
271 19th Avenue, So.
Minneapolis, MN 55455

Dear Dr. Karaken:

To assist the Financial Institutions Subcommittee in evaluating the need for modifications in the system of federal deposit insurance, you are requested to appear before the Subcommittee on September 19, 1985 at 10:00 a.m., in Room 2128 of the Rayburn House Office Building, to provide testimony on the need for changes in the existing system of federal deposit insurance and depository institution regulation and supervision. In your testimony, please comment specifically on the merits and demerits of the following widely discussed deposit insurance reforms:

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Fernand J. St Germain
Chairman

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TOBY ROTH, WISCONSIN

September 10, 1985

Dr. George Kaufman
Professor of Finance
Loyola University of Chicago
Chicago, ILL 60611

Dear Dr. Kaufman:

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September 10, 1985

Dr. David Pyle
Professor of Banking
University of California at Berkeley
350 Barrows
Berkeley, CA 94720

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